IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Petitioner, Thor Power Tool Company ("Thor"), seeks review of the judgment of the United States Court of Appeals for the Seventh Circuit, entered on September 29, 1977. The Court of Appeals, affirming the judgment of the United States Tax Court, held that the Commissioner of Internal Revenue ("Commissioner"), pursuant to the discretion granted him under section 471 of the Internal Revenue Code ("Code"), may require a taxpayer, who values inventory at the lower of cost or market, to carry excess and unsaleable inventory at cost instead of at its actual net realizable value (scrap value), until it is physically scrapped, thereby increasing taxable income by the amount that the cost of the inventory exceeds the scrap value. The Court of Appeals also held that the Commissioner, pursuant to the discretion granted him under section 166(c) of the Code, may limit the taxpayer's reserve for bad debts

to an amount no greater than a 6-year average of the taxpayer's bad debt experience, even though the taxpayer's actual calculations based on an individual evaluation of the collectability of each of its accounts receivable established that a larger reserve was required.

Each of the issues decided by the Court of Appeals, separately and in conjunction with each other, present important questions concerning the administration of the Internal Revenue Code which should be considered and resolved by this Court, including the extent to which the Commissioner may, at his discretion, reject generally accepted accounting principles. Moreover, this case involves questions as to which there are conflicts among the Courts of Appeals which should be resolved by this Court.

This case presents an issue of crucial financial importance to thousands of manufacturers, wholesalers and retailers who stock large quantities of replacement parts. The Commissioner would require all of them to value these parts at cost until they are scrapped, even though it is clear that substantial portions of these parts will never be sold and have only scrap value. The result is that either taxable income of the manufacturer or dealer is overstated or the parts must be prematurely scrapped to the detriment of the taxpayer and his customers.

OPINIONS BELOW

The opinion of the United States Tax Court, reported at 64 T. C. 154 (1975), is reproduced in the Appendix (A-6). The opinion of the United States Court of Appeals for the Seventh Circuit, reported at 563 F.2d 861 (1977), is reproduced in the Appendix (A-34).

JURISDICTION

The judgment of the Court of Appeals was entered on September 29, 1977 (A-33), and this Petition is filed within 90 days of the entry of that judgment. This Court's jurisdiction is invoked pursuant to 28 U. S. C. § 1254(1).

QUESTIONS PRESENTED

1. Whether the Court of Appeals, in conflict with the principles followed by the Fifth and Sixth Circuits, erred in holding that the Commissioner, at his discretion, could ignore generally accepted accounting principles and determine instead that Petitioner Thor, in calculating its taxable income, could not write down the cost of "excess goods"—primarily replacement parts held in quantities exceeding the number which Thor reasonably determined would be sold and which eventually would be scrapped—to net realizable value (*i.e.*, scrap value), where such writedown:

(a) is in accordance with generally accepted accounting principles, as required by section 446 of the Code, and was so found as a fact by the Tax Court and not questioned by the Court of Appeals;

(b) fulfills the requirement of "best accounting practice" in Thor's trade or business within the meaning of section 471 of the Code, and was so found as a fact by the Tax Court and not questioned by the Court of Appeals;

(c) is not prohibited by the applicable Treasury Regulations but is authorized by a realistic construction of them, and

(d) clearly reflected Thor's income for financial accounting purposes.

2. Whether the Court of Appeals erred in holding, contrary to the Court of Appeals for the First, Sixth and Ninth Circuits, that the Commissioner did not abuse his discretion by requiring that Thor's 1965 addition to its reserve for bad debts be calculated solely on the basis of a mechanical 6-year moving average of Thor's past bad debt experience—an approach that, contrary to the requirements of the Treasury Regulations, ignored the actual currently-existing facts and circumstances affecting the collectability of Thor's accounts receivable at the close of that taxable year.

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Relevant portions of sections 446, 471 and 166 of the Internal Revenue Code of 1954, 26 U. S. C. §§ 446, 471 and 166, and of the Treasury Regulations §§ 1.446-1(a), 1.471-2, 1.471-4, and 1.166-4 are set out in the Appendix (A-1 through A-5).

STATEMENT OF THE CASE

Factual Background.

The relevant facts are uncontroverted and are well-summarized in the Tax Court's Findings of Fact (A-8 through A-17).

Inventory Issue.

In calculating Thor's taxable income for 1964, the Commissioner disallowed $926,952 of Thor's "cost-of-goods-sold," which was the amount of Thor's 1964 writedown of its closing inventory for excess and unsaleable goods.

Thor manufactures hand-held power tools, parts and accessories for commercial and household uses and various commercial rubber products. A typical Thor tool contains from 50 to 200 individual parts, each of which Thor stocks to meet expected customer demand for replacement parts.

It is impossible to accurately predict future demand for each part, so liberal quantities are produced to avoid the need for additional production runs to replenish stock of a part that has been sold out. This would involve uneconomical tooling and set-up costs, which would increase the cost of the part and cause delays in supplying it to customers.

This inventory of replacement parts for a particular tool model is maintained so long as a significant population of the tool model remains in use, which may be for many years after Thor has discontinued producing it. Thor does not scrap such

parts until it is reasonably sure that there will be little or no future customer need.

In 1960, Thor initiated a procedure for reducing the inventory value of replacement parts and accessories for tools which it no longer produced by amortizing their cost over the 10-year period following their discontinuance. For the years 1960 through 1963 such writedowns, totalling $152,117, were not questioned by the Commissioner on audit. During 1964 an additional $22,090 was amortized.

Late in 1964, new management took over Thor and determined that Thor's assets were overvalued. Among other things, management was confronted with realistically valuing more than 44,000 different inventory items at Thor's factories and sales branches, including 33,670 replacement parts and accessories, many of which were held in quantities substantially exceeding any reasonably forseeable demand.

Because of the great number of different items and the relatively low value of each, it was impractical within realistic time limits, to individually estimate how many units of each item would be sold or used to manufacture finished goods. Instead, based on long manufacturing experience and a careful review of the situation, management employed two procedures to ascertain the extent to which inventory exceeded anticipated customer demand and to accurately value such excess stock.

Under the primary procedure, expected demand for each item was forecast on the basis of actual 1964 usage—actual sales for tools, parts and accessories, and actual production for raw materials, work-in-process, and production parts. With this data, the value of the inventory was reduced by a writedown sequence:

(1) that quantity of an item not in excess of 12 months anticipated demand was not written down;

(2) that quantity of an item in excess of 12 months but not in excess of 18 months anticipated demand was written down 50%;

(3) that quantity of an item in excess of 18 months but not in excess of 24 months anticipated demand was written down 75%; and

(4) that quantity of an item in excess of 24 months anticipated demand was written off.

The mechanics of this procedure are well-illustrated by the example from the Tax Court's Findings of Fact (A-11—A-12). As the example shows, actual usage of each item during 1964 was individually applied to estimate how many of each of the 44,000 different items would be sold or used in production. The portion determined to be saleable or useable was carried at full cost (or market value), and the portion deemed excess and unsaleable was written down to its net realizable value (*i.e.*, scrap value). The procedure is self-correcting in that any increase or decrease in sales from one year to the next automatically adjusts the amount of writedown for excess inventory in the latter year.

Although the foregoing procedure was used to determine the value of all excess inventory, supplementary writedowns (in addition to those determined by the primary procedure) were taken at two plants where the 1964 usage data was incomplete. This was done through percentage writedowns of 5, 10 or 50% of specified inventory categories at these locations.

The total writedowns for excess inventory items, primarily parts and accessories, for 1964 were as follows:

10-year amortization of parts for discontinued tools	$ 22,090
Primary writedown formula	744,030
Supplementary writedowns	160,832
	$926,952

Almost all of the excess inventory on hand at the end of 1964, was scrapped between 1965 and 1971.

At trial, Mr. Arthur R. Collins, who became President of Thor in late 1964, testified, without contradiction, that the sole purpose of the inventory valuation procedures was to determine accurate inventory values at the end of 1964, and that their income tax consequences were not considered at all (Tr. 107-108).

In referring to the inventory procedures followed by Thor in 1964, the Tax Court found as facts (A-15) that:

> "Petitioner's closing inventory at December 31, 1964, contained items which, in the opinion of petitioner's management, were unsalable in the normal course of business because they were in excess of reasonably foreseeable demand. *Generally accepted accounting principles required that petitioner reduce the value of its inventory to its net realizable value by eliminating the cost of such excess items.* If petitioner had failed to reflect such a reduction on a reasonable basis, an independent certified public accounting firm auditing its books would have been unable to issue an unqualified opinion certifying that petitioner's financial statements had been prepared in accordance with generally accepted accounting principles. The procedures utilized by petitioner's management to reduce the value of its 1964 closing inventory, *and in particular the procedures it used for eliminating the cost of excess stock,* were consistent with the generally accepted accounting principle of stating inventories at the lower of cost or market, and resulted in petitioner's stating the inventory in issue at its estimate of current net realizable value." (Emphasis added.)

In its opinion, the Tax Court stated (A-19—A-20):

> *"Petitioner produced distinguished members of the accounting profession who testified that the inventory valuation methods employed by petitioner were in accordance with generally accepted accounting principles and thoroughly convinced us that such was the case.* A write-down of inventory for excessive stock in this case was not merely desirable for accounting purposes, it was required in order to produce a certified balance sheet. Petitioner has, therefore, amply demonstrated that *the write-down of inventory*

was in accordance with generally accepted accounting principles and within the term, 'best accounting practice,' as that term is used in section 471 of the Code and the regulations promulgated under that section." (Emphasis added.)

Notwithstanding its own Findings of Fact, the Tax Court determined that Thor's inventory writedown procedures did not clearly reflect its income. Its conclusion seems to rest on two erroneous legal propositions:

(i) that even though a taxpayer's accounting procedures conform to generally accepted accounting principles and constitute "the best accounting practice in the taxpayer's trade or business," the Commissioner has the discretion to prohibit their use, which will be upheld unless it is "plainly arbitrary" and

(ii) that, as a matter of law, excess inventory cannot be written down to net realizable value for Federal income tax purposes because such a write-down is not expressly authorized by the Treasury Regulations.

The Court of Appeals affirmed for reasons similar to those adopted by the Tax Court, adding that the Commissioner did not abuse his discretion in requiring that Thor physically scrap the excess inventory before writing it down.

Bad Debt Issue.

In 1965, Thor added $136,150 to its reserve for bad debts on the basis of an individual analysis of all its accounts receivable. The Commissioner disallowed $74,791 of this amount.

Thor has used, pursuant to § 166 of the Code, the reserve method for calculating its bad debt expense for all pertinent years prior to and after 1965. At the end of 1965, as was done in 1964 and all subsequent years, each of Thor's accounts receivable from unrelated parties in excess of $100 was individually reviewed by credit clerks familiar with that account. If an account was deemed wholly uncollectable, a 100% reserve was established for it. Several accounts totalling $181,391

were determined to be uncollectable. Other overdue accounts were reserved against by 1 or 2%, depending on how long they were overdue. The determinations of the credit clerks were subsequently reviewed by the credit manager, then by Thor's treasurer, and finally by Thor's president.

Notwithstanding these careful procedures, the Commissioner determined that the reserve should be limited to a ceiling calculated by a 6-year average of Thor's past bad debt experience, a procedure which is known as the *Black Motor* formula derived from *Black Motor Co.,* 41 B. T. A. 300 (1940), *aff'd on other issues,* 125 F.2d 977 (6th Cir. 1942). The Commissioner gave no reasons to Thor (or to the lower courts) in what way Thor's bad debt evaluation was improper or inaccurate.

At trial, each of the four expert accounting witnesses who testified as to the validity of the *Black Motor* formula, declared that it was deficient in that it ignores present and future factors affecting collectability of accounts receivable (Tr. 217-220; 258-262; 307-308; 336-338).

Despite the Tax Court's Finding of Fact (A-16—A-17) recognizing the careful procedures utilized by Thor in calculating its 1965 addition to its reserve for bad debts, that Court held that the Commissioner had not abused his discretion by limiting the reserve to the 6-year average of Thor's previous bad debt experience, even though this ignored all current data on the collectability of Thor's accounts. Just as the Commissioner has given no reason for substituting this formula, the Tax Court's opinion does not explain how it reached its conclusion.

The Court of Appeals ". . . agree[d] with the Tax Court that the Commissioner's method of determining the reserve for bad debts, which gave preference to experience over estimates, was reasonable." Accordingly, it held that Thor did not establish that the Commissioner had abused his discretion.

REASONS FOR GRANTING THE WRIT.

I.

This Case Presents Important Questions Concerning the Extent to Which the Commissioner May Disregard Provisions of the Code and of the Treasury Regulations That Require Generally Accepted Accounting Principles to Be Followed in Determining Taxable Income—Questions Which Have Resulted in Recurring Litigation and Which Have Produced a Division of Opinion Among the Courts of Appeals.

The decision of the Court of Appeals on the inventory issue is the first, as far as Thor can determine, in which any court has held that the Commissioner has virtually unlimited discretion to set aside inventory procedures used by a taxpayer, in calculating his taxable income, even though they fully conform to generally accepted accounting principles and constitute "the best accounting practice" in the taxpayer's trade or business within the meaning of section 471 of the Code. To this extent, the decision of the Court of Appeals conflicts in principle with the decision of the Court of Appeals for the Fifth Circuit in *Space Controls, Inc.* v. *Comm'r,* 322 F. 2d 144 (5th Cir. 1963), which held that a taxpayer was permitted to write down inventory to its net realizable value because this procedure constituted the best accounting practice. The Fifth Circuit emphasized, *id.* at 149:

> "Considering the sharply defined rule that accounting may be different for business-financial purposes and for tax purposes, the Regulations here accord extraordinary tax significance to financial accounting of inventories."

The same principle was adopted in *E. W. Bliss Co.* v. *United States,* 224 F. Supp. 374, 382 (N. D. Ohio 1963), *aff'd on the opinion below,* 351 F.2d 449 (6th Cir. 1965).

A decision by this Court on the inventory issue would resolve a substantial number of cases that are now pending before the United States Tax Court and other Federal courts, and will

forestall the initiation of court action in a much greater number of cases that are now in various stages of administrative review within the I.R.S., all involving the writedown of excess inventory. The *Amicus* Brief being filed by the National Association of Manufacturers in support of this Petition will attempt to identify the extent of this actual and potential litigation.

The reason for this widespread controversy is that in recent years the I.R.S. has, without any change in the applicable Treasury Regulations, commenced to disallow writedowns of excess inventory. Most manufacturers of mechanical and electrical products, including household appliances, television and radio, automobiles and machinery, as well as wholesalers and retailers of them, maintain extensive stocks of replacement parts to service their customers. Because of the inability to predict which parts are going to be troublesome, portions of this inventory are inevitably in excess of what will be sold, and will eventually be scrapped when such parts are no longer needed to serve customers. In short, the discretion of the Commissioner to disregard generally accepted accounting principles in relation to inventory accounting is a recurring question of public importance which should be resolved by this Court. See also the *Amicus* Brief filed by the United States Chamber of Commerce.

The bad debt issue presented in the instant case arises because the Commissioner attempted, as he has done with increasing frequency in other cases, to apply a 6-year average of bad debt experience—commonly known as the *Black Motor* formula[1]—as a limit of the amount of Thor's bad debt reserves. This approach has resulted in at least 41 reported cases before the Tax Court and other Federal courts.[2] Contrary to the decision of the Court of Appeals in this case, the Courts of Appeals for the First, Sixth and Ninth Circuits have refused to permit the

1. *Black Motor Co.,* 41 B. T. A. 300 (1940), *aff'd on other grounds,* 125 F. 2d 977 (6th Cir. 1942), *acq.* 1944 C. B. 3.

2. See generally Whitman, Gilbert & Picotte, *The Black Motor Bad Debt Formula: Why It Doesn't Work and How to Adjust It,* 35 J. of Taxation 366 (1971).

Commissioner to use arbitrary calculations to the exclusion of relevant current data on collectability. See *Calavo, Inc.* v. *Comm'r,* 304 F.2d 650 (9th Cir. 1962); *Travis* v. *Comm'r,* 406 F.2d 987 (6th Cir. 1969); and *Rhode Island Hospital Trust Co.* v. *Comm'r,* 29 F. 2d 339 (1st Cir. 1928), *rev'g* 8 B. T. A. 555 (1927). See also *Atlantic Discount Co.* v. *United States,* 473 F. 2d 412 (5th Cir. 1973), which is arguably consistent with the decision of the Seventh Circuit in the instant case.

Furthermore, the Commissioner's determination on the bad debt issue is in square conflict with Treasury Regulation § 1.166-4(b)(1).

The fact that the Court of Appeals sustained the action of the Commissioner on *both* the inventory and bad debt issues not only produces incongruous results, but also highlights the necessity for this Court to provide guidance concerning the extent to which the Commissioner may exercise his discretion in rejecting generally accepted accounting principles. In valuing its excess inventory, Thor primarily utilized a formula directly based on historical data to value 44,000 different items of inventory which practically could not be valued on an item-by-item basis. Notwithstanding the fact that this procedure was in accordance with generally accepted accounting principles, the Court of Appeals held that the Commissioner did not abuse his discretion in determining that such method did not clearly reflect Thor's income. Conversely, although Thor evaluated its accounts receivable on an item-by-item basis, the Court of Appeals held that the Commissioner did not abuse his discretion by requiring Thor to value these accounts on the basis of an historical formula.

In effect, the Court of Appeals afforded the Commissioner virtually unlimited discretion to disregard generally accepted accounting principles with respect to both aspects of the valuation process that are at issue in this case. However, when it enacted sections 446, 471 and 166(c) of the Code, Congress did not intend the Commissioner to have such broad authority, independent of any objective standards, applied inconsistently,

to impose his own view of "proper" accounting on taxpayers whose accounting procedures unequivocally comply with generally accepted accounting principles, are the best accounting practice in their trade or business, and are consistent with the applicable Treasury Regulations.

II.

The Court of Appeals Erroneously Held That Thor Was Not Permitted, in Accordance with Generally Accepted Accounting Principles, to Write Down the Excess and Unsaleable Goods in Its Inventory from Cost to Net Realizable Value Where This Commonly-Used Accounting Procedure Is Authorized by the Code, Permissible Under Treasury Regulations, and Clearly Reflects Thor's Taxable Income.

A. Thor's Writedowns of Excess Inventory to Net Realizable Value, Which Are in Conformity with Generally Accepted Accounting Principles and Constitute the Best Accounting Practice, Are Presumed by Sections 446 and 471 of the Code and by the Treasury Regulations Thereunder to Clearly Reflect Thor's Taxable Income.

As the Findings of Fact of the Tax Court show, Thor established, through its independent accountants and expert witnesses, representing four of the "Big 8" international accounting firms,[3]

3. The importance of this case is attested to by the preeminent practicing accountants who testified on behalf of Thor. These included:

The late Robert M. Trueblood, C. P. A. since 1937, and at the time of trial the Chairman of the Board of Touche Ross & Co.; past president of the American Institute of Certified Public Accountants ("AICPA"), then Chairman of the AICPA 9-member Commission on the Objectives of Accounting; former member of both of the AICPA Long-Range Objectives Committee and of the prestigous Accounting Principles Board, which for many years was the accounting profession's primary authority on matters of accounting principles and practice. (Tr. 177-180.)

Newman T. Halvorson, C. P. A. since 1930, and at the time of trial the national partner-in-charge of Technical Auditing

(Footnote continued on next page.)

that generally accepted accounting principles required it to write down its excess inventory to net realizable value; that its procedures for doing so conformed to generally accepted accounting principles and constituted the best accounting practice in its trade or business; that the result of these writedowns was to clearly state its financial accounting income; and that, had Thor refused to write down its inventory in 1964, its independent auditors would not have been able to render an unqualified opinion ("certified") concerning its profit and loss statement and balance sheet.

Under these factual circumstances, the Code and the Regulations create a presumption that a taxpayer's taxable income is the same as its financial income.

Section 446 of the Code states in mandatory language that:

> "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."

(Footnote continued from preceding page.)

and Accounting Services for Ernst & Ernst; member of the AICPA Accounting Principles Board. (Tr. 283-286.)

Bertrand J. Belda, C. P. A. since 1931, and at the time of trial the national partner-in-charge of Management Consulting Services for Ernst & Ernst, specializing in management accounting, including matters of inventory valuation. He participated in drafting the comments which the Division of Federal Taxation of the AICPA submitted in 1972 to the Treasury Department, at the Treasury's request, on the proposed revisions of the Regulations governing the valuation of inventories, discussed at p. 23 *infra*. (Tr. 263-270.)

Frank T. Weston, C. P. A. since 1939, at the time of trial Chairman of the Committee of Accounting and Auditing Standards of Arthur Young & Co.; a member of AICPA Accounting Principles Board and of the 9-member Commission on the Objectives of Accounting. (Tr. 340-343.)

Howard B. Burris, C. P. A. since 1950, and at the time of trial a partner of S. D. Leidesdorf & Co., a member of the Committees on Auditing Procedure and on Accounting Principles of that firm; and a member of the AICPA Committee on Auditing Procedure. (Tr. 315-316.)

Section 446(b) permits the Commissioner to require a different method of accounting by the taxpayer only if the taxpayer's method "does not clearly reflect income". Otherwise, the taxpayer's accounting method, including subordinate practices such as Thor's excess inventory writedown procedures, is controlling for tax accounting purposes. See Treas. Reg. § 1.446-1 (a)(1).

Treasury Regulation § 1.446-1(a)(2) elaborates upon the statute:

> "A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will *ordinarily be regarded as clearly reflecting income. . . .*" (Emphasis added.)

Section 471 of the Code, governing inventory accounting, provides:

> "Whenever . . . the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

This language imposed dual requirements for inventory accounting *on both the taxpayer and the Commissioner*: (i) it must conform to the "best accounting practice in the trade or business" of the taxpayer, and (ii) it must clearly reflect income.

After discussing these two criteria, Treasury Regulation § 1.471-2(b), in effect for the year at issue, states:

> "It follows, therefore, that inventory rules *cannot be uniform* but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. . . . ***An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a***

general rule, be regarded as clearly reflecting his income." (Emphasis added.)

The Tax Court found as a fact that Thor's method of accounting for valuing excess inventory both conformed to generally accepted accounting principles and was the "best accounting practice" in its trade or business. That finding, as a matter of law, created a presumption that Thor's procedures clearly reflected its income. Inasmuch as the Commissioner introduced no evidence on this point, the presumption should establish that Thor's income was clearly stated. This should conclude the matter.

The Court of Appeals nullifies this presumption by declaring that the Commissioner is free to determine whether the best accounting practice clearly reflects taxable income. The opinion is devoid of any standard by which the Commissioner is to make his determination. In fact, once he has acted, "the taxpayer must show that the Commissioner's act was 'plainly arbitrary' " (A-40).

This surprising position is apparently founded on two concepts:

(i) that financial accounting is not oriented to the annual accounting concepts required for income tax accounting (A-40); and

(ii) that the case law gives the Commissioner discretion, subject only to not being plainly arbitrary, to set aside a taxpayer's accounting procedures, regardless of whether they conform to generally accepted accounting principles or constitute the best accounting practice (A-40).

1.

The Court bases its conclusion that tax accounting is not directed to the annual period upon the specialized prepaid income cases, *Schlude* v. *Comm'r*, 372 U. S. 128 (1963), and *American Automobile Association* v. *United States*, 367 U. S. 687 (1961),

and upon a 1930 case in which the taxpayer compiled its inventories according to the "base stock method," which is designed to switch income between years and therefore is improper under both generally accepted accounting principles and tax accounting, *Lucas* v. *Kansas City Structural Steel Co.*, 281 U. S. 264 (1930). Although the prepaid income cases are thought to depart from generally accepted accounting principles, their outcome was substantially influenced by this Court's interpretation of the legislative intent. 367 U. S. at 694-698. Moreover, as has been shown above, section 471 makes tax accounting for inventories specially dependent on generally accepted accounting principles; except for the general strictures of section 446, there is no comparable provision in the Code for prepaid income.

It is far more helpful to look at authoritative accounting sources as to how important the annual period is to financial accounting for inventories.

The American Institute of Certified Public Accountants' ("A. I. C. P. A.") Accounting Principles Board Statement No. 4, entitled "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," declares in chapter 2:

> "Changes in Financial Position—the Income Statement. The income statement for a period . . . presents an indication in conformity with generally accepted accounting principles of the results of the enterprise's profit-directed activities during the period. The information presented in an income statement is *usually considered the most important information provided by financial accounting* because profitability is a paramount concern to those interested in the economic activities of the enterprise." (Emphasis added.)

Accounting Research Bulletin No. 43, Ch. 4, applies this to inventory accounting.[4]

4. Relevant portions of ARB 43 are Exhibit 28 of the record in this case. The binding nature of formal opinions issued by the Accounting Principles Board is set out in the introductory material

(Footnote continued on next page.)

Statement 4 of that chapter of ARB 43 specifies:

> ". . . the major objective in selecting [an inventory] method should be to choose the one which, under the circumstances, *most clearly reflects periodic income*." (Emphasis added.)

Statement 5 provides:

> "A departure from the cost basis of pricing the inventory is *required* when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the *current period*. This is generally accomplished by stating such goods at a lower level commonly designated as *market*." (Emphasis added.)

In applying Statement 5, Statement 6 sets forth the limit of the "market" value to net realizable value:

> "As used in the phrase *lower of cost or market* the term *market* means current replacement cost (by purchase or by reproduction, as the case may be) except that:
>
> "(1) Market should not exceed the net realizable value (*i.e.*, estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal). . . ."

The expert accounting witnesses testified without contradiction that Statements 5 and 6 represent the relevant generally accepted accounting principles.

2.

The case law does not support the unqualified assertion of the Court of Appeals that the Commissioner's determination—that

(Footnote continued from preceding page.)

to ARB 43, and is recognized by the profession. This includes specifically ARB 43, which, as one of the expert witnesses testified, the accounting profession regards as the "bible"—the controlling statement of what constitutes "generally accepted accounting principles." (Tr. 183-185).

a taxpayer's inventory procedures do not clearly reflect income—will not be set aside unless the taxpayer can show that it is plainly arbitrary. None of the cases cited by the Court of Appeals (or the Tax Court) for this proposition involved situations where the taxpayer's accounting procedures were in conformity with generally accepted accounting principles or constituted the best accounting practice. Two of those cases involved attempts by taxpayers to defer commission income,[5] and the others involved inventory procedures which were not in conformity with generally accepted accounting principles.[6]

On the contrary, in the only cases involving inventory procedures which conformed to generally accepted accounting principles, the courts, unlike the Court of Appeals in the present case, refused to allow the Commissioner to substitute his own "preferred" procedure. In *E. W. Bliss Co.* v. *United States*, 224 F. Supp. 374 (N. D. Ohio 1963), in which the Court of Appeals expressly adopted the District Court's opinion, 351 F. 2d 449 (6th Cir. 1965), the District Court permitted a taxpayer to write down to net realizable value partially completed presses being built to the customer's specifications on the fixed contract. The Court stated, 224 F. Supp. at 382:

> "An evaluation of the evidence outlined above leaves no room for doubt that plaintiff's method of valuing its work in process inventory is in harmony with generally accepted

5. *Brown* v. *Helvering*, 291 U. S. 193 (1934) (reserve against commission income); *Comm'r* v. *Hansen*, 360 U. S. 446 (1959) (deferral of commission on customer notes discounted by automobile dealers with finance companies).

6. *Lucas* v. *Kansas City Structural Steel Co.*, 281 U. S. 264 (1930) ("base stock" inventory method is improper); *Bangor Punta Operations, Inc.* v. *United States*, 466 F. 2d 930 (7th Cir. 1972); ("practical capacity method" for allocating manufacturing overhead to inventory is improper); *Photo-Sonics, Inc.*, 42 T. C. 926 (1964), *aff'd*, 357 F. 2d 656 (9th Cir. 1966) ("prime cost method" for allocating manufacturing overhead to inventory is improper); *All-Steel Equipment Inc.*, 54 T. C. 1749 (1970), *aff'd*, 467 F. 2d 1184 (7th Cir. 1972) ("prime cost method" for allocating manufacturing overhead to inventory is improper).

accounting principles. . . . These conclusions are compelled by . . . the testimony of the taxpayer's witnesses, all of whom are certified public accountants of wide and extensive experience in auditing accounts of large publicly owned corporations. . . .

"It was established also that an inventory valued in accordance with generally accepted accounting principles may be considered as one that conforms 'as nearly as may be to the best accounting practice in the trade or business.' "

The Court explicitly approved the proposition that the limit of "market" value is net realizable value as defined in Statement 6 of Accounting Research Bulletin 43, Ch. 4, quoted at page 18 above. *Id.* at 379. In reaching this result, the Court observed that ". . . there can be no open market for a partially finished press built to specifications of a particular purchaser . . ." so that the taxpayer was entitled to " 'use such evidence of fair market price at the date or dates nearest the inventory as may be available'." *Id.*, at 379. This reasoning equally applies to excess replacement parts.

Similarly, the Fifth Circuit Court of Appeals held in *Space Controls, Inc.* v. *Comm'r*, 322 F. 2d 144 (5th Cir. 1963), that a taxpayer incurring a loss in manufacturing military trailers under a fixed price contract was entitled to write down its closing inventory to net realizable value. The Court specifically rejected the Commissioner's arguments, *almost identical to the ones made by him in this case*, that no writedown was permitted because all of the conditions of the Regulations were not fulfilled, the goods were not damaged or imperfect, the net realizable value was less than replacement cost, and the loss had not been realized because the goods had not yet been delivered. In reaching its conclusion, the Court stressed the importance that section 471 of the Code and Treasury Regulation § 1.471-2 attribute to financial accounting rules for inventory, *id.* at 149:

"Considering the sharply defined rule that accounting may be different for business-financial purposes and for tax

purposes, the Regulations here accord extraordinary tax significance to financial accounting of inventories."

Even under the Court of Appeals' "clearly arbitrary" standard, the Court erred in sustaining the action of the Commissioner in the instant case. The Commissioner would require Thor to value its inventory at the end of 1964 at $927,000 greater than its net realizable value. Nowhere does the Commissioner contend or the lower courts' opinions suggest that Thor's procedures undervalued this inventory. The Commissioner's overvaluation would increase Thor's cost-of-goods-sold by the same amount and in turn equally overstate its taxable income. It is hard to see how such a large overvaluation, which continues year after year, is not arbitrary.

B. Thor's Inventory Valuation Procedures Are Not Prohibited by the Treasury Regulations, But Are Authorized by a Realistic Construction of Them.

In attempting to determine whether Thor's procedures clearly reflected its taxable income, the Court of Appeals analyzes both the specific and the general provisions of the Regulations, on the premise that unless the Regulations authorize a particular procedure, the Commissioner has complete discretion to set aside that procedure as not clearly reflecting income (A-41).

This premise determines the outcome, because the Commissioner, Thor and both of the lower courts agree that the Regulations do not explicitly cover the problem of excess goods. But more importantly, the premise raises the Regulations to the status of an enabling statute, plainly contrary to the rule established by this Court in such cases as *Manhattan General Equipment Co.* v. *Comm'r*, 297 U. S. 129, 134-35 (1936):

"The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the

power to adopt regulations to carry into effect the will of Congress as expressed by the statute."

The Court of Appeals' opinion cites no cases or other authority supporting its premise that silence or ambiguity of the Regulations constitutes a prohibition, nor has Thor been able to find any. On the contrary, the cases establish that Thor's inventory writedown procedure is proper so long as it is *not inconsistent* with the Regulations. See *Fort Howard Paper Co.*, 49 T. C. 275 (1967), distinguishing *Photo-Sonics, Inc.*, 42 T. C. 926 (1964), *aff'd*, 357 F.2d 656 (9th Cir. 1966). The Tax Court itself has forcefully rejected the Commissioner's argument that an inventory method had to be authorized by the Regulations. In *Hutzler Brothers Co.*, 8 T. C. 14, 28 (1947), it said:

> "All of the regulations are as consistent with petitioner's position as they are with that of respondent. . . . It is simpler and more rewarding to seek the meaning of the statute itself than of ambiguous and largely irrelevant administrative interpretations."

The idea that the Regulations must authorize writedowns of excess merchandise is particularly troublesome in light of the established doctrine that taxpayers are entitled to reduce gross income by the cost-of-goods-sold as a constitutional right under the Sixteenth Amendment. *Lela Sullenger*, 11 T. C. 1076, 1077, *app. dis.* (5th Cir. 1950), *nonacq.* 1949-1 C. B. 6, *acq.* 1952-2 C. B. 3, *nonacq.* 1976-1 C. B. 1; *cf. Burnet* v. *Logan*, 283 U. S. 404 (1931); *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179 (1918); *Comm'r* v. *Weisman*, 197 F. 2d 221 (1st Cir. 1952). Accordingly, a taxpayer's right to deduct cost-of-goods-sold does not depend on legislation, thereby making inapplicable the rule of *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, 440 (1934), that *deductions* from gross income are a matter of legislative grace. *A fortiori*, the taxpayer's right to have his inventory accurately valued for cost-of-goods-sold purposes does not depend on regulatory grace.

It is inherently unfair for the silence or ambiguity of the Treasury Regulations to operate against the taxpayer when the Treasury has been aware, at least since the early 60's, that the Regulations do not cover the problem of valuing excess inventory. See Patton, *Inventory Procedures: Recent Developments in Internal Revenue Service's Attitude*, 23 N. Y. U. Institute on Federal Taxation, 839, 850 (1965). Indeed, in 1972, at its own request, the Treasury received from the A. I. C. P. A.'s Division of Federal Taxation a statement on proposed amendments to the inventory Regulations under § 471, which strongly declared that one of the shortcomings of the Regulations was its failure to explicitly cover excess inventory.

Even though Thor is entitled to write down its excess inventory to net realizable value regardless whether the Regulations expressly authorize it, the fact is that two provisions of the Regulations, properly construed, would authorize the writedown. Neither explicitly covers excess inventory, but both embody the generally accepted accounting principles set forth at pp. 14-16 above.

Treasury Regulation § 1.471-4(b) provides for a writedown of normal goods to net realizable value where market conditions are not normal:

> "Where no open market exists or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory *as may be available*, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith. . . ."

Market conditions are not normal for excess quantities of replacement parts which are of value only to someone needing that part.

Also consistent with generally accepted accounting principles, § 1.471-2(c) specifically permits taxpayers to write down the value of subnormal goods in inventory to net realizable value without having to scrap the merchandise.

". . . Any goods in an inventory which *are unsalable at normal prices or unusable in the normal way* because of damage, imperfections, shop wear, changes of style, odd or broken lots, or *other similar causes* . . . should be valued at *bona fide* selling prices less direct cost of disposition. . . ." (Emphasis added.)

Although the Court of Appeals concluded that the term "other similar causes" used in the Regulation does not apply to excess goods because they are "not distinguishable from other units of inventory", it did not explain the relevance of such a requirement, nor do the cases cited by it support it (A-42).

The Court's opinion would also require Thor to offer replacement parts at lower prices within 30 days of the year-end valuation date in order to write them down. This literal application of § 1.471-2(c) is wholly impractical and has been rejected for obsolete goods. *Queen City Woodworks & Lumber Company* v. *Crooks,* 7 F. Supp. 684, 685 (S. D. Mo. 1934).

The very nature of excess stock precludes literal application of the 30-day rule. Excess stock exists, by definition, where a portion of the supply of an item in inventory is saleable at normal prices, while remaining quantities of that item cannot be sold at any price (except as scrap). To apply the 30-day rule, the taxpayer would have to offer to give away the excess quantities, while attempting to merchandise the saleable portion at normal prices. This perforce would destroy the market for the saleable quantities. As Thor's president testified, service parts are useful only to replace damaged or worn out parts in tools previously sold, so price changes for parts have little or no effect on demand. (Tr. 108.)

C. Because Thor's Writedown of Excess Inventory Clearly Reflected Thor's Financial Accounting Income, It Clearly Reflected Its Taxable Income.

As a final reason justifying the Commissioner's determination that Thor's method did not clearly reflect its income, the Court

of Appeals states (A-46) that Thor's accounting experts ". . . did not testify that its 1964 income had been clearly reflected in its tax returns. . . ." This is true—because they were not qualified tax experts—but irrelevant. They did testify unequivocally and without contradiction that Thor's writedowns were required to correctly state its financial income. It follows—pursuant to the presumption created by the Code and Regulations in favor of the taxpayer's accounting method if it conforms to generally accepted accounting principles and is the best accounting practice—that Thor's taxable income was also correctly stated.[7]

D. Requiring Excess Inventory to Be Carried at Original Cost Until It Is Scrapped Is Contrary to the Provisions of Sections 446 and 471 of the Code.

The Court of Appeals concludes its discussion by stating that the Commissioner was entitled, in his discretion, to require losses on excess inventory to be realized by scrapping rather than permit writedowns to net realizable value when the taxpayer's inventory valuation procedures determined that such inventory was in excess of foreseeable customer demand and was therefore unsaleable.

The cases cited by the court do not support its conclusion.[8] On the contrary, it conflicts with the only case closely on point.

7. The Court of Appeals has raised the issue (A-45) whether all of the excess inventory arose during 1964 or whether some of it arose in earlier years. The Tax Court, by its pretrial order, ruled that evidence on this issue would not be introduced at the initial trial. Thus, the year or years in which the excess arose can be determined by remand. The years 1961 through 1963 are not barred by the statute of limitations.

8. *Brown* v. *Helvering,* 291 U. S. 193 (1934) (reserve against commission income for contingent cancellations of insurance policies); *United States* v. *American Can Co.,* 280 U. S. 412 (1930) (*write-up* of inventory from cost to a higher market value by the taxpayer); *Lucas* v. *American Code Co.,* 280 U. S. 445 (1930) (reserve for contingent commission liability which was the subject of litigation); *American Can Co.* v. *Bowers,* 35 F. 2d 832 (2nd Cir. 1929), *cert. denied,* 281 U. S. 736 (1930) (same issue as in *United States* v. *American Can Co., supra*).

In *C-O-Two Fire Equipment Co.* v. *Comm'r*, 219 F. 2d 57, 59 (3rd Cir. 1955), the Third Circuit Court of Appeals rejected the Commissioner's argument that obsolete goods could not be written down until they were scrapped.

To require scrapping is wholly inconsistent with sections 446 and 471 of the Code, which base tax accounting on the taxpayer's financial accounting methods provided they conform to generally accepted accounting principles and constitute the best accounting practice. Generally accepted accounting principles prohibit delaying writedowns of excess goods until they are scrapped, because this has the effect of overstating the current year's income and understating the income of the year in which the goods are scrapped. From the viewpoint of the revenues, the scrapping test creates a much greater opportunity for a taxpayer to manipulate income by carrying worthless excess inventory at cost, and then scrapping it in a year where it will create a maximum income tax benefit.

The effect of the Court's decision conflicts with the growing awareness that society must conserve its resources. Efficiencies of production dictate that replacement parts be produced in sufficient quantities to avoid costly tooling and set-up charges for reruns. Adequate quantities of spare parts directly benefit the consumers by making spare parts more readily available and less expensive. This permits the customer to keep a tool in use rather than have to uneconomically replace it because one small part of it has broken. Such a sound policy, which is customary among thousands of manufacturers, inevitably will result in the production of excess quantities of some replacement parts.

By insisting that these excess quantities cannot be reduced to their net realizable value until they are actually scrapped, the Commissioner is presenting the taxpayer with an unrealistic and uneconomical choice: either overvalue your inventory and pay too much tax or scrap the excess parts to the detriment of your customers—and to society generally.

III.

The Court of Appeals, in Conflict with Decisions of Other Courts of Appeals, Erroneously Held That Section 166(c) of the Code Gives the Commissioner the Discretion to Mechanically Limit a Taxpayer's Reserve for Bad Debts to a Six-Year Average of Its Bad Debt Experience to the Exclusion of Any Current Facts Concerning the Collectability of Its Accounts.

It is undisputed, as the Court of Appeals acknowledged, that at the close of 1965 the collectability of all of Thor's accounts receivable was estimated by the Thor personnel most familiar with each account and their estimates were reviewed by three levels of management (A-47). These careful, detailed computations resulted in a total addition to Thor's bad debt reserve of $135,150. In spite of Thor's exacting computations, the Commissioner recomputed what he considered to be a "reasonable addition" to the reserve by applying the six-year average, or *Black Motor* formula, to the 1965 accounts receivable.[9] The Commissioner divided the total of accounts written off by Thor during the tax year in question and the five preceding years by the total of year-end receivables for all six years. The resulting percentage was then applied to the 1965 year-end receivables, and the $74,790.80 by which Thor's claimed deduction exceeded the product of this calculation was disallowed.

The Commissioner's mechanical application of the *Black Motor* formula is inconsistent with the mandates of section 166(c) of the Code, with the applicable Treasury Regulations, and with the decisions of other Courts of Appeals that have considered the same or similar issues. Indeed, application of the *Black Motor* formula in the instant situation is contrary to the *Black Motor* case itself where the Board of Tax Appeals held that all of the facts and circumstances had to be considered

9. This procedure is derived from *Black Motor Co.*, 41 B. T. A. 300 (1940), *aff'd on other grounds*, 125 F. 2d 977 (6th Cir. 1942), *acq.* 1944 C. B. 3.

in determining what constituted a "reasonable addition" to bad debt reserves and that the use of a mechanical formula for this purpose was only permissible when facts necessary to determine a "reasonable addition" to bad debt reserves were unavailable.[10]

Section 166(c) of the Code provides that, in lieu of charging specific bad debts against its income, a taxpayer such as Thor which has properly elected the reserve method ". . . shall be allowed (in the *discretion* of the Secretary or his delegate) a deduction for a *reasonable* addition to a reserve for bad debts." (Emphasis added.) The statute sets forth two distinct requirements: (i) an exercise of discretion by the Commissioner in order to arrive at (ii) a reasonable addition to the reserve. Treasury Regulation § 1.166-4(b)(1) states that what is reasonable ". . . shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition."[11]

Notwithstanding the statutory mandate that the Commissioner exercise his discretion in determining additions to bad debt reserves, he did not do so, and the Court of Appeals in turn abdicated its responsibility for determining whether the Commissioner had properly exercised or had abused his discretion. In characterizing its role, that Court held "As we have stated before, the issue thus presented 'is whether the Commissioner's view is reasonable.' [Citations omitted.] If it is, the inquiry is ended" (A-48). Since use of a historical average is not *per se* reasonable or unreasonable, but becomes so only when viewed in the context of particular facts, the Court of Appeals (and the Tax Court) abandoned its review function and deferred entirely to the use of the *Black Motor* formula by the Commissioner.

10. The opinion in *Black Motor*, 41 B. T. A. at 304, states:

> "The test, however, is whether the amount ultimately determined, regardless of formula, constitutes a reasonable addition to petitioner's reserve. What constitutes a reasonable addition will depend upon the facts and circumstances of the business engaged in with relation to general business conditions. A method or formula that produces a reasonable addition to a bad debt reserve in one year, or a series of years, may be entirely out of tune with the circumstances of the year involved."

11. Indeed, in Rev. Rul. 76-362, 1976-2 C. B. 45, the Commissioner himself recognized that the *Black Motor* formula is not *per se* reasonable:

> ". . . [I]f the taxpayer can demonstrate that an amount greater than the amount determined under the *Black Motor* formula is reasonable, in light of the facts existing at the close of the taxable year, the taxpayer may compute the greater amount to be added to the reserve for bad debts."

This Revenue Ruling refers to the Tax Court decision in *Westchester Development Co.*, 63 T. C. 198 (1974), *acq.* 1975-2 C. B. 2, which found that a mechanical application of the *Black Motor* formula was an abuse of discretion by the Commissioner.

Other Courts of Appeals have for good reason been unwilling to permit the Commissioner to apply the *Black Motor* formula at will, requiring instead a showing that the statutory mandate of exercising discretion be followed. In *Calavo, Inc.* v. *Comm'r*, 304 F. 2d 650 (9th Cir. 1962), the Ninth Circuit correctly held that application of the *Black Motor* formula without regard to the uncollectability of a specific account was inconsistent with section 166(c). In its remand, that Court directed the Tax Court to resubmit the question to the Commissioner ". . . for an exercise of his discretion free from his erroneous conception that the circumstances particularly affecting a specific debt must be completely disregarded in determining the reasonableness of additions to [the] reserve." *Id.* at 655.[12]

Rhode Island Hospital Trust Co. v. *Comm'r*, 29 F. 2d 339 (1st Cir. 1928), *rev'g* 8 B. T. A. 555 (1927), was decided prior to *Black Motor*, but it involved a similar failure by the Commissioner to exercise his discretion. The Commissioner disallowed a bad debt deduction of $87,500 and refused to permit

12. The Ninth Circuit later qualified *Calavo* in *United States* v. *Haskel Engineering & Supply Co.*, 380 F. 2d 786 (9th Cir. 1967), *rev'g* 17 Am. Fed. Tax R. 2d 861, 66-1 U. S. Tax Cas. ¶ 9257 (S. D. Cal. 1966), apparently on the ground that the Commissioner had reviewed the factors urged by the taxpayer and properly elected to ignore them. The taxpayer in *Haskel* apparently did not determine that any of its receivables were wholly uncollectable.

the addition of any portion thereof to the taxpayer's reserve for bad debts. The Court of Appeals remanded the case for a determination, in light of the particular facts, of the amount which should be added to the taxpayer's reserve, observing ". . . if the Commissioner and the Board of Tax Appeals exercised their discretion, on legal and reasonable grounds, this court could not substitute its discretionary judgment for that of the tax authorities. But if there was [a] failure really to exercise discretion, or error of law in its exercise, then the court must grant relief." 29 F. 2d at 341.

See also *Travis* v. *Comm'r*, 406 F. 2d 987 (6th Cir. 1969), in which the Commissioner's refusal to permit an addition to a bad reserve equal to price decreases arising from the renegotiation of dance studio contracts constituted a failure to take into account actual facts concerning collectability of amounts due under the contracts. The Court of Appeals held that this failure to take into account facts relating to collectability rendered the calculation of the reserve by the Commissioner "unrealistic and 'clearly erroneous.'" *Id.* at 991.

The conflict between the Courts of Appeals thus raises the issue of whether the Commissioner is to be allowed unfettered discretion to apply the *Black Motor* formula, or other similar mechanical approach, as a ceiling upon a taxpayer's bad debt reserve, or whether, as is true in the First, Sixth and Ninth Circuits, he must consider the actual facts in an attempt to arrive at a reasonable result.[14] Thus, mechanical application of the *Black Motor* formula, adopted by the Court of Appeals in the instant case, is not only inconsistent with the decisions of

14. The approach of the First, Sixth and Ninth Circuits has been followed in various other cases, including *Norfolk Industrial Loan Ass'n* v. *United States*, 26 Am. Fed. Tax R. 2d 70-5296, 70-5304, 1970-2 U. S. Tax Cas. ¶ 9527 (E. D. Va. 1970); *Richardson* v. *United States*, 330 F. Supp. 102 (S. D. Tex. 1971); *Gold-Pak Meat Co.*, 30 T. C. M. (CCH) 337, 1971 T. C. M. (P-H) ¶ 71,083 (1971); and *Duffey* v. *Lethert*, 11 Am. Fed. Tax R. 2d 1317, 63-1 U. S. Tax Cas. 88,182 (D. Minn. 1963).

other Courts of Appeals but is also inconsistent with section 166(c) of the Code, with Treas. Reg. § 1.166-4(b)(1), and, indeed, with the *Black Motor* case itself.

CONCLUSION

For all of the foregoing reasons, Petitioner respectfully requests that a Writ of Certiorari issue to review the judgment of the Court of Appeals for the Seventh Circuit.

Respectfully submitted,

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APPENDIX

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The pertinent sections of the Internal Revenue Code and the related Treasury Regulations for the period in question are:

Section 446, 26 U. S. C. § 446, provided in part:

"General Rule for Methods of Accounting.

"(a) GENERAL RULE.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

"(b) EXCEPTIONS.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

"* * *"

Treas. Reg. § 1.446-1 (T. D. 6282, filed 12/24/57; republished in T. D. 6500, filed 11/25/60; amended by T. D. 6584, filed 12/20/61) provided in part:

"General Rule for Methods of Accounting.

"(a) *General rule.* (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term 'method of accounting' includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. . . . Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. . . .

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

"* * *"

Section 471, 26 U. S. C. § 471, provided:

"General Rule for Inventories.

"Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

Treas. Reg. § 1.471-2 (T. D. 6336, filed 12/1/58; republished in T. D. 6500, filed 11/25/60) provided in part:

"Valuation of Inventories.

"(a) Section 471 provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

"(b) It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be

given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with §§ 1.471-1 through 1.471-9. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

"(c) The bases of valuation most commonly used by business concerns and which meet the requirements of section 471 are (1) cost and (2) cost or market whichever is lower. . . . Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including secondhand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether subparagraph (1) or (2) of this paragraph is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

"* * *"

Treas. Reg. § 1.471-4 (T. D. 6336, filed 12/1/58; republished in T. D. 6500, filed 11/25/60) provided in part:

"Inventories at Cost or Market, Whichever is Lower.

"(a) Under ordinary circumstances and for normal goods in an inventory, 'market' means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—

(1) Of goods purchased and on hand, and

(2) Of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand. . . .

"(b) Where no open market exists or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

"* * *"

Section 166, 26 U. S. C. § 166, provided in part:

"Bad Debts.

* * *

"(c) Reserve for Bad Debts.—In lieu of any deduction under subsection (a) [permitting the deduction for any debt which becomes wholly worthless within the taxable year], there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

"* * *"

Treas. Reg. § 1.166-4 (T. D. 6403, filed 7/30/59; republished in T. D. 6500, filed 11/25/60; amended by T. D. 6728, filed 5/4/64) provided in part:

"Reserve for Bad Debts.

"(a) *Allowances of deduction.* A taxpayer who has established the reserve method of treating bad debts and

has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of § 1.166-1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

"(b) *Reasonableness of addition to reserve*—(1) *Relevant factors.* What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years and the total amount of the existing reserve.

(2) *Correction of errors in prior estimates.* In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

"* * *"

64 UNITED STATES TAX COURT REPORTS

THOR POWER TOOL COMPANY, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 4795-69. Filed May 6, 1975.

Where the petitioner valued its inventory at the lower of cost or market, the Commissioner did not abuse the discretion vested in him under sec. 471, I.R.C. 1954, by reducing the petitioner's cost of goods sold and restoring to income the amount by which the petitioner reduced the value of its 1964 closing inventory to reflect the current net realizable value rather than current replacement cost of units of inventory determined to be excess under procedures in accordance with generally accepted accounting principles.

In computing petitioner's cost of goods sold for the taxable year 1964, the Commissioner did not abuse the discretion vested in him under sec. 471, I.R.C. 1954, by disallowing an addition of $22,090 in the taxable year 1964 to a reserve for inventory valuation account (which addition decreased ending inventory and increased cost of goods sold) to provide for reduction in the value of inventory of replacement parts and accessories stocked for tools no longer manufactured by petitioner.

The Commissioner did not abuse the discretion vested in him under sec. 166(c) by disallowing a portion of petitioner's addition to its reserve for bad debts for the taxable year 1965.

Mark H. Berens, Lee N. Abrams, and *John E. Allen,* for the petitioner.

Seymour I. Sherman, for the respondent.

GOFFE, *Judge*: The Commissioner determined deficiencies in petitioner's Federal income tax as follows:

Taxable year	*Deficiency*
1963	$545,997.64
1965	59,701.35

The deficiency for the taxable year 1963 results primarily from a disallowance in full of a net operating loss deduction carried back from the taxable year 1964. Adjustments to the taxable year 1964 are, therefore, involved herein. Certain adjustments in the statutory notice of deficiency have been resolved by the parties leaving the following issues for decision:

(1) Where the petitioner valued its inventory at the lower of cost or market, did the Commissioner abuse the discretion vested in him under section 471,[1] I.R.C. 1954, by reducing the petitioner's cost of goods sold and restoring to income the amount by which the petitioner reduced the value of its 1964 closing inventory to reflect the current net realizable value[2] rather than current replacement cost of units of inventory determined to be excess under procedures in accordance with generally accepted accounting principles?

(2) In computing petitioner's cost of goods sold for the taxable year 1964, did the Commissioner abuse the discretion vested in him under section 471, I.R.C. 1954, by disallowing an addition of $22,090 in the taxable year 1964 to a reserve for inventory valuation account (which addition decreased ending inventory and increased cost of goods sold) to provide for reduction in the value of inventory replacement parts and accessories stocked for tools no longer manufactured by petitioner?

(3) Did the Commissioner abuse the discretion vested in him under section 166(c), I.R.C. 1954, by disallowing a portion

1. Unless otherwise noted, all Code section references are to the Internal Revenue Code of 1954 in effect during the taxable years in issue.

2. "Net realizable value" consists of the estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal. Accounting Research Bull. No. 43, p. 31 (1961).

of petitioner's addition to its reserve for bad debts for the taxable year 1965?

Findings of Fact

Some of the facts have been stipulated. The stipulation of facts and attached exhibits are incorporated by reference.

Petitioner Thor Power Tool Co. is a corporation organized under the laws of the State of Delaware. At the time the petition was filed and during the years in controversy, its principal office and place of business was in Aurora, Ill. Its corporate income tax returns for the taxable years 1960 to 1965, inclusive, were filed with the District Director of Internal Revenue, Chicago, Ill.

During 1964, petitioner (exclusive of its foreign subsidiaries) operated 4 manufacturing plants and 23 sales and service branches in the United States and 1 branch in Canada. It manufactured hand-held power tools, parts, and accessories for industrial, contractor, service trades, and household uses in three plants located at Aurora and LaGrange Park, Ill., and Los Angeles, Calif. (collectively the Tool Division). A fourth plant at Cincinnati, Ohio (the Rubber Division), manufactured products such as rubber-covered rolls, belts, specialty hose, and molded rubber articles. The sales and service branches were engaged in sales of power tools, parts, and accessories, and service of power tools; they did not handle rubber products.

The three manufacturing plants of the Tool Division maintained inventories of (i) raw materials; (ii) work-in-process; (iii) finished parts (for use in production of tools and for sale as service parts) and accessories; and (iv) completed tools. The manufacturing plant of the Rubber Division maintained inventories of raw materials, work-in-process, and completed products. The sales and service branches maintained inventories of service parts, accessories, and completed tools. In addition, some of petitioner's distributors and some of its large industrial customers maintained their own stocks of service parts. The

record does not disclose the extent of such inventories nor the effect they might have had on the petitioner's ability to liquidate its own inventories.

At all pertinent times prior to 1964, petitioner's inventory was valued on the basis of the lower of cost or market. Petitioner's income tax returns from 1964 to 1970 indicated that inventory continued to be valued on that basis.

From time to time, petitioner discontinued the production of certain tools but maintained an inventory of replacement parts and accessories for such tools. In 1960, petitioner opened an inventory contra account entitled, "Reserve for Inventory Valuation" (RIV). The RIV account was created for the purpose of reducing the value of closing inventory each year to reflect the value of replacement parts and accessories for tools no longer produced by petitioner.

On December 31, 1960, the RIV account was credited with $116,244.52, effecting a 100-percent writeoff of parts and accessories for tools which went out of production during and prior to 1950, a 90-percent write-down of parts and accessories for tools which were discontinued in 1951, 80 percent for 1952, et cetera, with corresponding partial write-downs for the amortization of parts and accessories for tools discontinued between 1953 and 1958 and a 10-percent write-down of parts and accessories for tools which went out of production in 1959. The effect of such a procedure was to amortize the cost of inventory of such parts and accessories over a 10-year period. An additional credit of $30,966.35 was made to the account in 1961 resulting in a balance in the RIV account on December 31, 1961, of $147,210.87. On December 31, 1963, the balance of the account was $152,117. During the first three quarters of calendar year 1964, $22,090 was added (credited) to the RIV account resulting in a balance of $174,207 as of September 30, 1964.

The credit balance in the RIV account at the end of each year was reflected on petitioner's income tax return for that year as a reduction of closing inventory. Therefore, the net addi-

tion to the RIV account during any particular taxable year increased petitioner's cost of goods sold and reduced its taxable income for that year.

In August 1964, Stewart-Warner Corp., which then owned approximately 20 percent of petitioner's outstanding common stock, entered into an agreement with petitioner to purchase substantially all of petitioner's assets. As a result of an investigation and audit conducted incident to this purchase agreement, Stewart-Warner concluded that petitioner's assets were substantially overstated and its liabilities understated. The purchase agreement was rescinded by mutual agreement in early December 1964, at which time Stewart-Warner agreed to provide management assistance to petitioner.

New management concluded that existing inventory quantities were excessive. Prior management had reflected inventory at its full value, including portions of the inventory which new management viewed to be in excess of anticipated market demand.

Incident to closing the books and preparing the financial statements as of December 31, 1964, petitioner's new management undertook an analysis of its closing inventory. A physical inventory was taken at all factories and branches. Various amounts were written off or written down, including a complete writeoff of inventory deemed obsolete. The remaining items of inventory consisted of the following:

Raw materials	4,297
Work-in-process	1,781
Finished parts (service and production) and accessories	33,670
Finished tools	4,344
Total number of inventory items	44,092

Because of the large number of remaining inventory items and the relatively small quantity or low value of each item, petitioner's new management concluded that it was impractical to

try to determine precisely how many units of each item would be sold or used. Based on its experience in the manufacturing business, its familiarity with inventory problems of manufacturing companies, and its review of the situation, petitioner's new management employed two procedures in determining units of inventory in excess of anticipated demand.

Where such information was available, under the first procedure the demand for each item of inventory in 1965 and later years was forecast in terms of 1964 sales or "usage."[3] Employing an aging schedule, gross usable inventory was then reduced as follows:

(1) Items not in excess of 12 months' anticipated demand were not written down.

(2) Items in excess of 12 months' anticipated demand but not in excess of 18 months' anticipated demand were written down 50 percent.

(3) Items in excess of 18 months' anticipated demand but not in excess of 24 months' anticipated demand were written down 75 percent.

(4) Items in excess of 24 months' anticipated demand were completely written off.

The mechanics used to forecast future requirements of the inventory items can best be illustrated by the following which shows the percentage writeoff of units of hypothetical items A, B, C, D, and E. One hundred units of each item were on hand at December 31, 1964, but the number of units sold or used in 1964 varied from 20 to 100.

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3. For finished tools, usage was based on 1964 sales; for finished parts and accessories, usage was based on 1964 sales of service parts, and for parts incorporated in tools, usage was based upon 1964 production; for raw materials and work-in-process, usage was based on 1964 production.

ANTICIPATED DEMAND

Item	Units on hand at 12/31/64	Units sold or used in 1964	0-12 Months	13-18 Months	19-24 Months	+24 Months	Percent of write-down
A	100	20	20	10	10	60	
			0%	50%	75%	100%	
			0	5	7.5	60	= 72.5%
B	100	40	40	20	20	20	
			0%	50%	75%	100%	
			0	10	15	20	= 45.0%
C	100	60	60	30	10	0	
			0%	50%	75%	100%	
			0	15	7.5	0	= 22.5%
D	100	80	80	20	0	0	
			0%	50%	75%	100%	
			0	10	0	0	= 10.0%
E	100	100	100	0	0	0	
			0%	50%	75%	100%	
			0	0	0	0	= 0.0%

The second procedure employed by the new management was used to eliminate the cost of excess inventory at petitioner's LaGrange Park and Cincinnati plants, because the data showing the number of units used at those locations was not adequate to permit an accurate forecast of future requirements. Petitioner's management concluded that additional write-downs were necessary to reflect the net realizable value of its inventories at those two plants as follows: (i) 5 percent for tool parts and motor parts at LaGrange Park; (ii) 10 percent for raw material, work-in-process, and finished goods at Cincinnati, and raw material, manuals and name plates, and work-in-process at LaGrange Park; and (iii) 50 percent for hardware at LaGrange Park.

Petitioner then combined the amounts of write-down of the inventory determined by application of the two procedures described above. It did not reduce the balance in the inventory account by that amount; but, instead, entered that sum as a credit to the RIV account. The closing balance of the account on December 31, 1964, was $1,079,069 representing a net increase of $926,952 over the closing balance of the account on December 31, 1963. The December 31, 1964, balance in the RIV account resulted from the following: (i) The prior closing balance as of December 31, 1963, of $152,117, representing net additions from 1960 to 1963, inclusive, for amortization over a 10-year period of parts and accessories stocked for tools no longer produced; (ii) interim additions for the same purpose for January 1, 1964, to September 30, 1964, in the amount of $22,090; (iii) $744,030 in excess inventory determined by application of procedure 1, outlined above; and (iv) $160,832 in excess inventory determined by application of procedure 2, outlined above.

In the statutory notice of deficiency, the Commissioner reduced petitioner's 1964 net operating loss with the following explanation:

> The deduction of $22,279,949.71 claimed for cost of goods sold is disallowed to the extent of $1,079,069.00 representing writedown of inventory due to anticipated losses because it has not been established that such amount constitutes an allowable deduction under section 162 or any other section of the Internal Revenue Code of 1954.

The adjustment did not take into account the 1964 opening balance in the RIV account in the amount of $152,117 which represented total additions claimed on prior returns. Respondent concedes that the adjustment to 1964 is excessive to the extent of such opening balance. The net adjustment to taxable year 1964 remaining in issue is, therefore, $926,952 consisting of $744,030 and $160,832 added to the RIV account as of December 31, 1964, to reflect excess inventory and $22,090 in additions to the RIV account during the first three quarters of calendar year 1964 to reflect the amortization of parts and accessories stocked for tools no longer manufactured.

At the end of each year since 1964, petitioner has reduced its ending inventory for excess items using the first procedure described above. In order to correct what it believed to be partially inaccurate results derived from application of the first

procedure, management further adjusted the value of ending inventory resulting in a $6,802 decrease in taxable income in 1970 and a $97,373 increase in taxable income in 1971.

Since late 1964, petitioner's management has not attempted to sell at reduced prices its excess parts, which comprised in each year from 70 percent to 82 percent of the excess inventory costs. The market for such parts was confined to owners of the related tools who purchased replacement parts when and if needed and would not buy parts not needed merely because of price reductions.

Petitioner reduced prices on some finished tools where management believed that price reductions would stimulate sufficient additional sales to increase its gross income. Most of the finished tools in excess supply, however, were specialized products, and petitioner's management concluded that their potential market was so limited that a price reduction would not stimulate additional sales to increase gross receipts above what they would be if the salable quantities were sold at current prices. The record does not reflect prices, dates, quantities, or other relevant details of such efforts.

Petitioner's management concluded that the only secondary market for excess work-in-process (consisting of partially completed parts or tools) was as scrap. Petitioner attempted to sell excess raw materials in 1964, but these efforts met with very little success because users of such hardware items as nuts, bolts, screws, and washers prefer to purchase them from an established supplier, who can be relied upon to furnish the items according to specifications and to warrant their quality, rather than from another manufacturer disposing of surplus in a secondary market. The record does not reflect prices, quantities, or other relevant details of such efforts.

Of the $1,079,069 balance in the RIV account at December 31, 1964, $846,960 related to inventories at Aurora, Los Angeles, and the 23 sales and service branches. Dispositions of

such inventory as scrap during the period 1965 through 1971, at the Aurora and Los Angeles factories only, amount to about 78 percent of the total inventory reserve provided for those two factories and the sales branches. Data on scrap dispositions at petitioner's branches was not presented.

Petitioner's closing inventory at December 31, 1964, contained items which, in the opinion of petitioner's management, were unsalable in the normal course of business because they were in excess of reasonably foreseeable demand. Generally accepted accounting principles required that petitioner reduce the value of its inventory to its net realizable value by eliminating the cost of such excess items. If petitioner had failed to reflect such a reduction on a reasonable basis, an independent certified public accounting firm auditing its books would have been unable to issue an unqualified opinion certifying that petitioner's financial statements had been prepared in accordance with generally accepted accounting principles. The procedures utilized by petitioner's management to reduce the value of its 1964 closing inventory, and in particular the procedures it used for eliminating the cost of excess stock, were consistent with the generally accepted accounting principle of stating inventories at the lower of cost or market, and resulted in petitioner's stating the inventory in issue at its estimate of current net realizable value.

Petitioner made no effort to determine the purchase or reproduction cost as of December 31, 1964, of each item of inventory which it determined to be excess nor was any effort made to determine the market value of each article on hand at the inventory date. Units of a given item of inventory were essentially fungible. There was no segregation or earmarking of specific units and no distinction was apparent between specific units so as to distinguish those carried at full value from those written down or written off.

At all times pertinent hereto, petitioner has utilized the reserve method for claiming losses from bad debts. For the

taxable year 1965, it claimed an addition to its reserve for bad debts in the amount of $136,150, in order to bring the balance of the reserve at yearend to $228,947.60.

In computing the addition to its reserve for the taxable year 1965, petitioner treated all intercompany accounts as fully collectible. The accounts receivable from unrelated parties at the Cincinnati Rubber Division were reviewed by personnel familiar with them. This review indicated that two accounts were uncollectible, and a 100-percent reserve was set up for them. A 1-percent reserve was set up for the remaining receivables of the Cincinnati Rubber Division.

The accounts receivable of petitioner's Tool Division were analyzed by the credit clerks responsible for those accounts. All individual accounts which had balances exceeding $100 and were more than 90 days past due were specifically evaluated as to collectibility, account by account. A 100-percent reserve was set up for those accounts which the credit personnel determined were wholly uncollectible, and for an identical ratio of the accounts which had balances of less than $100 and were more than 90 days past due. Judgments made by credit clerks responsible for the particular accounts were reviewed by the credit manager having supervision over the clerk involved, and subsequently by petitioner's treasurer. A reserve of 2 percent was set up for accounts from 30 to 90 days past due as well as those accounts over 90 days past due which were not treated as wholly uncollectible. A reserve of 1 percent was set up for accounts which were less than 30 days past due. Finally, petitioner's president conducted an overall review of the accounts receivable and approved the proposed reserve provision.

In the statutory notice of deficiency, the Commissioner disallowed $74,790.80 of the $136,150 claimed by petitioner as an addition to the bad debt reserve for the taxable year 1965. In computing the adjustment to the reserve for bad debts, respondent divided the total amount of accounts written off from 1960 through 1965 ($940,413) by the total of yearend receivables for those 6 years ($30,063,802) to arrive at a factor of 3.128 percent. He then applied this percentage to the petitioner's receivables at December 31, 1965 ($4,927,967), resulting in a figure of $154,156.80 (which is $10 too high due to a mathematical error), which respondent determined represented the allowable reserve as of that date. This amount was subtracted from the December 31, 1965, balance in the reserve account of $228,947.60 to reach the $74,790.80 adjustment.

Opinion

The Commissioner disallowed petitioner's write-down of its ending inventory for the taxable year 1964 in the amount of $1,079,069, which adjustment is now conceded to be $926,952. The statutory notice of deficiency described the adjustment to inventory affecting costs of goods sold as disallowable under section 162 or any other section of the Internal Revenue Code.

Cost of goods sold is not allowable under section 162 and petitioner need not prove that an increase in cost of goods sold is allowable under section 162. *Lela Sullenger,* 11 T.C. 1076 (1948). Cost of goods sold is an offset to gross sales. Sec. 1.61-3(a), Income Tax Regs.; cf. *Burnet* v. *Logan,* 283 U.S. 404 (1931); *Doyle* v. *Mitchell Brothers Co.,* 247 U.S. 179 (1918).

Although cost of goods sold does not represent a deduction in the technical sense, such a description of the adjustment did not mislead or surprise petitioner as to the issue involved nor has petitioner demonstrated that the language of the statutory notice was in any way prejudicial. Petitioner cannot, therefore, be sustained due to the inappropriate description of the adjustment contained in the statutory notice of deficiency. *Standard Oil Co.,* 43 B.T.A. 973 (1941), affd. 129 F. 2d 363 (7th Cir. 1942), cert. denied 317 U.S. 688 (1942); *Luke* v. *Commissioner,* 351 F. 2d 568 (7th Cir. 1965), affg. a Memorandum Opinion of this Court.

The adjustments to 1964 ending inventory which remain for our consideration consist of the following:

(1) A downward valuation of $744,030 due to excess items computed by petitioner based primarily on 1964 usage of the items;

(2) A downward valuation of $160,832 due to excess items based upon flat percentages applied to inventories at the LaGrange Park and Cincinnati plants where usage information was not available; and

(3) A downward valuation of $22,090 to reflect amortization of parts and accessories stocked for tools no longer manufactured by petitioner.

All three of the above-described procedures were employed by petitioner to reduce the value of the 1964 ending inventory to what petitioner considered to be the net realizable value. All three of the procedures were designed to write down the value because there were units on hand which management deemed to be in excess of the *future* needs of petitioner's business. There was no segregation of the inventory which management determined to be excessive.

The details of the procedures employed to compute the adjustments are described fully in our findings of fact. In summary, they may be described as follows:

(1) Petitioner assumed that future needs for each item would be the same as such needs during 1964 and determined how many months of supply thus remained on hand at December 31, 1964. The values of items on hand in excess of the forecast needs for 1 year were written down in varying percentages, depending upon the number of periods items were forecast to be used.

(2) Petitioner did not have adequate records to show the usage in 1964 of various items of inventory at its LaGrange and Cincinnati plants. Therefore, it applied arbitrary percentages in writing down specified classifications of

inventory; i.e., raw materials, work-in-process, and finished goods.

(3) For the inventory of spare parts accessories stocked for tools no longer manufactured by petitioner, it amortized the cost of such items over a 10-year period.

Respondent contends that the procedures which petitioner used to identify and value excess inventory pursuant to the 1964 write-down of such excess to net realizable value failed to clearly reflect income because such procedures were speculative, they were not sanctioned by the regulations, and would allow petitioner to circumvent annual accounting by anticipating or delaying losses which must be taken in the taxable year in which the event giving rise to the losses occurred, not the taxable year such losses are discovered. Alternatively, respondent argues that for purposes of section 446(e) of the Code, petitioner changed its method of accounting in the taxable year 1964, the year in which the first two procedures were initiated. Finally, should we hold for the petitioner on the first two theories, respondent asserts that annual accounting requires that the procedures applied to the ending inventory must be consistently applied to the beginning inventory in order to clearly reflect 1964 income.

Petitioner contends that there is no specific statutory authority contrary to the general requirements of sections 446 and 471 of the Code which require the valuation of inventory to be in accordance with generally accepted accounting principles and to clearly reflect income. Petitioner produced distinguished members of the accounting profession who testified that the inventory valuation methods employed by petitioner were in accordance with generally accepted accounting principles and thoroughly convinced us that such was the case. A write-down of inventory for excessive stock in this case was not merely desirable for accounting purposes, it was required in order to produce a certified balance sheet. Petitioner has, therefore, amply demonstrated that the write-down of inventory was in

accordance with generally accepted accounting principles and within the term, "best accounting practice," as that term is used in section 471 of the Code and the regulations promulgated under that section. However, petitioner must also show that the method clearly reflects taxable income. *Photo-Sonics, Inc.*, 42 T.C. 926 (1964), affd. 357 F. 2d 656 (9th Cir. 1966).

Two sections of the Code are involved: section 446[4] because the valuation of inventory constitutes a method of accounting and section 471[5] because that section grants authority to the Commisioner to prescribe the method for taking inventories. The sections will be discussed together because both contain the requirement that the inventory method must clearly reflect income.

Sections 446 and 471 impose a heavy burden of proof on petitioner. We described that burden as follows in *All-Steel Equipment Co.*, 54 T.C. 1749, 1761 (1970), affd. on this issue 467 F. 2d 1184 (7th Cir. 1972):

> The wording of sections 446(b) and 471 makes clear that, in matters of accounting methods, the respondent is invested with broad discretion. If a taxpayer's method of accounting does not clearly reflect income, the respondent

4. SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) General Rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or *if the method used does not clearly reflect income,* the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income. [Emphasis added.]

5. SEC. 471. GENERAL RULES FOR INVENTORIES.

Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and *as most clearly reflecting the income.* [Emphasis added.]

> may compute income "under such method as, in * * * [his] opinion * * * does clearly reflect income." Sec. 446(b). More specifically, section 471 provides that "inventories shall be taken * * * on such basis *as the Secretary or his delegate may prescribe* as conforming as nearly may be to the best accounting practice in the trade or business and as most clearly reflecting the income." These provisions have been a part of our tax law for many years, and they have been interpreted as imposing an extremely heavy burden of proof on taxpayers challenging the respondent's determinations—the Supreme Court has gone so far as to require a showing that such determinations are "plainly arbitrary." *Lucas* v. *Structural Steel Co.*, 281 U.S. 264 (1930). See also *Photo-Sonics, Inc.* v. *Commissioner, supra; Finance & Guaranty Co.* v. *Commissioner,* 50 F.2d 1061 (C.A. 4, 1931), affirming 19 B.T.A. 1313 (1930); *Commissioner* v. *Joseph E. Seagram & Sons, Inc.*, 394 F.2d 738 (C.A. 2, 1968), reversing 46 T.C. 698 (1966). * * * [Emphasis supplied.]

Proof that the method is in accordance with generally accepted accounting principles does not also prove that the method clearly reflects income under the income tax law. *American Automobile Assn.* v. *United States,* 367 U.S. 687 (1961).

Petitioner does not challenge the validity of the applicable income tax regulations promulgated under sections 446 and 471. Instead, petitioner argues that the inventory valuation procedures it employed fit within the applicable regulations.[6]

6. Portions of the regulations expressing the general requirements of secs. 446 and 471 of the Code are as follows:

METHODS OF ACCOUNTING IN GENERAL

Sec. 1.446-1 General rule for methods of accounting.

(a) *General rule.* (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. * * *

(Footnote continued on next page.)

Section 1.471-2(b), Income Tax Regs., was amended by T.D. 7285 (approved September 13, 1973), 1973-2 C.B. 163, after the briefs were filed in the instant case. The amendment deleted the following language:

> An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, *as a general rule*, be regarded as clearly reflecting his income. [Emphasis added.]

The amendment added other language which will not be set forth here because we hold that the amendment to the regulations cannot be applicable to this case. *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939). Moreover, our decision would be no different if the amendment to the regulations were applicable.

(Footnote continued from preceding page.)

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. *However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income.* A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will *ordinarily* be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year. [Emphasis added.]

Sec. 1.471-2 Valuation of inventories.

(a) Section 471 provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) *It must clearly reflect the income.*

(b) It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation *so long as the method or basis used is in accord with sections 1.471-1 through 1.471-11.* [Emphasis added.]

The foregoing general provisions of the Income Tax Regulations requiring that the method must clearly reflect income were not satisfied by the testimony of petitioner's witnesses. The test in the instant case as to whether the method used by petitioner clearly reflected its income for the taxable year 1964 involves other sections of the Income Tax Regulations which are more specific in nature. Petitioner must demonstrate that its inventory method satisfied the requirements of those sections.

Petitioner, prior to 1964, valued its inventory on the basis of the lower of cost or market and it contends that its valuation of the ending inventory for 1964 was likewise valued under that method. To prevail in that contention, petitioner must show that its method came within the ambit of section 1.471-2(c) or section 1.471.4, Income Tax Regs.

Section 1.471-4, Income Tax Regs., provides as follows:

> Sec. 1.471-4. Inventories at cost or market, whichever is lower.
>
> (a) Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—
>
> (1) Of goods purchased and on hand, and
>
> (2) Of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, under which the taxpayer is protected against actual loss, which goods must be inventoried at cost.
>
> (b) Where no open market exists or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or

> others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.
>
> (c) Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

Substantially similar provisions have been included in the regulations since 1920. Art. 1584, Regs. 45. For purposes of section 1.471-4(a), Income Tax Regs., market has generally been held to mean replacement cost. *D. Loveman & Son Export Corp.*, 34 T.C. 776 (1960), affd. 296 F.2d 732 (6th Cir. 1961), cert. denied 369 U.S. 860 (1962); *Cleveland Automobile Co.* v. *United States*, 70 F.2d 365, 369 (6th Cir. 1934), cert. denied 293 U.S. 563 (1934). However, under exceptional circumstances and provided all requirements are complied with, inventory may be valued under the provisions of section 1.471-4(b) or 1.471(c), Income Tax Regs.

Concerning the rationale underlying the lower of cost or market method of valuing inventory, in *D. Loveman & Son Export Corp.*, supra at 798, we stated:

> Whatever the defects of the lower of cost-or-market method in actual practice, its underlying theory, as stated in Finney and Miller, Principles of Accounting (Intermediate) (5th ed. 1958), is as follows (p. 251):
>
> "The cost-or-market basis of inventory pricing conforms with an old rule of accounting conservatism often stated as follows: Anticipate no profit and provide for all possible losses. If market purchase prices decline, it is assumed that selling prices will decline with them; reducing the inventory valuation to market purchase price reduces the profit of the period when the cost price decline took place and transfers the goods to the next period at a price which will presumably permit the earning of a normal gross profit on their sale. If the market purchase price increases, the inventory is valued at cost so that a profit will not be anticipated."

Thus, the lower of cost or market method is a limited and acceptable exception to the principles of annual accounting which otherwise would preclude recognition of an unrealized loss. *Space Controls, Inc.* v. *Commissioner,* 322 F.2d 144 (5th Cir. 1963). Of course, that does not mean that closed transactions or identifiable events may not be required in order to establish or substantiate the value of inventory. Accordingly, the Commissioner's above-quoted regulations are understandably detailed and specifically prescribe the acceptable methods for determining market value.

It is undisputed that units not in excess of projected current usage are normal goods within the meaning of section 1.471-4, Income Tax Regs. Only units in excess of projected current usage were designated by petitioner as excess inventory and written down to net realizable value. The petitioner's method of determination of excess inventory splits individual items or articles into two or more classifications for purposes of valuation. See *Fruehauf Trailer Co.*, 42 T.C. 83, 106 (1964), affd. 356 F.2d 975 (6th Cir. 1966), cert. denied 385 U.S. 822 (1966). Yet, the excess units were otherwise indistinguishable from other units of the same item of inventory. See *D. Loveman & Son Export Corp.*, 34 T.C. 776, 799 (1960), affd. 296 F.2d 732 (6th Cir. 1961), cert. denied 369 U.S. 860 (1962).

Petitioner contends that its excess inventory comes within cember 31, 1964, the inventory date; therefore, petitioner does not argue that the inventory should be valued under section

1.471-4(b), Income Tax Regs. Instead, petitioner argues that, for purposes of section 1.471-4(a), the term "market" means replacement or reproduction cost only "under ordinary circumstances." Petitioner contends that the excess inventory was an extraordinary circumstance. The record does not support such a contention. Instead, it shows that the acquisition or production of such slow-moving units was a recurring, ordinary, and necessary incident of manufacturing, marketing, and maintaining petitioner's products. Petitioner's use of the 10-year amortization of replacement parts and accessories for discontinued items began in 1960 and the practice will presumably continue because petitioner will likely cease manufacturing certain tools in the future. In addition, we think it is a fair inference from the record that petitioner's accumulation of excess inventory occurred over a period of several years.

Petitioner did not compare the replacement market value of each item with its cost to determine which was lower. Instead, it wrote down the value of the entire inventory applying arbitrary percentages. The percentages were based upon management's considered opinion as to its *ultimate salability*. We find the explanation of the percentages vague. If we were to approve a concept permitting a write-down of inventory based upon an otherwise unsupported opinion of the taxpayer as to its ultimate salability we would, within some unknown limits, permit the taxpayer to determine how much tax it wanted to pay for a given year. For obvious reasons, the percentages used by management in this case could not provide a guide for management to use in all cases. We cannot approve the percentages used in the write-down based upon the record before us. Accordingly, we hold that the three procedures utilized by petitioner in valuing its ending inventory for the taxable year 1964 do not come within section 1.471-4, Income Tax Regs.

Petitioner contends that its excess inventory comes within section 1.471-2(c), Income Tax Regs., which provides as follows:

> Sec. 1.471-2. Valuation of inventories.
>
> (c) The bases of valuation most commonly used by business concerns and which meet the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower. (For inventories by dealers in securities, see sec. 1.471-5.) Any goods in an inventory which are *unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes*, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether subparagraph (1) or (2) of this paragraph is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made. [Emphasis added.]

Petitioner argues that its excess inventory comes within the description of items of unsalable inventory underscored in the quoted regulations above. Such an interpretation would require us to hold that the unsalability of excess inventory resulted from causes similar to those applicable to damaged goods, imperfections, shop wear, changes of style, or odd or broken lots. We disagree with petitioner. All of the terms used in the phrase describe the units of inventory themselves and describe differences which would distinguish those units of inventory from other units of inventory. Excess inventory is not so distinguishable. It is commingled with the other inventory and it is excessive not because of its physical characteristics but because of management's view as to future demand for it. See *Cleveland Automobile Co.* v. *United States*, 70 F.2d 365, 369 (6th Cir. 1934); *D. Loveman & Son Export Corp., supra.*

Inventory falling within the categories set forth in the regulations above are to be valued by reference to actual offerings of such goods within 30 days after the inventory date. Petitioner points out its inability to comply with the 30-day provision without forcing down the price of other normal units within an item. This further demonstrates that excess inventory is not includable in the term "other similar causes" discussed above. Any goods in an inventory which are unsalable at normal prices or not usable in the normal way because of damage, imperfections, shop wear, changes of style, or odd or broken lots, would not compete in the marketplace with normal goods. They would produce a lower price and would not force down the price of normal goods because the discount in the marketplace is due to the reason that such goods are inferior.

Whether the so-called "30-day rule" applies is, therefore, not dispositive of the issue. Petitioner cannot come within the terms of section 1.471-2(c), Income Tax Regs.

Petitioner cites as authority for its procedures several cases which we find not in point for the reasons stated below.

In *Space Controls, Inc.* v. *Commissioner,* 322 F.2d 144 (5th Cir. 1963), reversing and remanding a Memorandum Opinion of this Court, the Court of Appeals reversed us to permit the write-down of work-in-process claimed by petitioner. That case involved trailers being produced pursuant to a contract for a fixed unit price. It is not necessary to decide whether we will follow that case in our consideration of the instant case because it is factually distinguishable. The price at which the finished product would be sold was fixed and the Court of Appeals found that the value placed upon work-in-process satisfied the test of section 1.471-4(b) as to a market where the taxpayer has offered the goods at a price lower than the current price. Here, petitioner made no such offer nor could it predict with any degree of accuracy what the items of excess inventory would sell for on the market in the future. In the case of applying procedure No. 1, they predicted that an item of excess inventory not used within 2 years was worth nothing but it was not based upon a fixed price 2 years away.

Petitioner relies upon *S. G. Sample Co.* v. *Commissioner,* 23 F.2d 671 (5th Cir. 1928), in which the Court of Appeals reversed the Board of Tax Appeals because it precluded the taxpayer from showing that a 25-percent general inventory markdown represented a true market value. In the instant case, petitioner was permitted to offer any evidence it desired to demonstrate the propriety of the write-down. Its evidence fails to convince us of the reasonableness of the write-down.[7]

The District Court cases relied upon by petitioner are likewise inapplicable.

In *Wood & Ewer Co.* v. *Ham,* 14 F.2d 995 (D. Me. 1926), buyers for some of the departments in a retail store who were experts in market values took inventory and testified that the values used represented the market value. Such evidence was a far cry from the instant case where arbitrary discounts were used for broad categories of inventory with no explanation of the basis for the discounts.[8]

Buck's Booterie v. *O'Malley,* an unreported case (Neb. 1951, 43 AFTR 1341, 51-2 USTC par. 9449) was a jury case.

Fides Publishers Assn. v. *United States,* 263 F.Supp. 924 (N.D. Ind. 1967), involved a concession on the part of the Government that a writeoff of unsalable inventory was proper to clearly reflect income. The taxpayer presented an accountant who testified as to the rate of writeoff and the Government produced no witness. The rate was based upon subsequent sales of items of the inventory. The rates used in the instant case were arbitrary and not explained other than being the opinion of management.

Petitioner cites four early cases of the Board of Tax Appeals.

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7. *Gem Jewelry Co.*, a Memorandum Opinion of this Court dated Jan. 13, 1947.

8. *Gem Jewelry Co., supra.*

Lord Motor Car Co., 5 B.T.A. 818 (1926), involved an inventory of used cars. The taxpayer valued the cars at their cost less 25 percent to represent the costs of sale. The estimate was supported by evidence of subsequent sales at the prices used by the taxpayer. The percentages used by petitioner here were not reflected in the prices of actual subsequent sales. Instead, the percentages are unexplained theoretical discounts based upon 1 year's use of each item in procedure No. 1 and upon flat percentages without explanation in procedure No. 2.

No reasons are given for approval of the method used by the taxpayer in *Fred S. Stewart Co.*, 5 B.T.A. 436 (1926). The opinion merely approves the valuation method used by the taxpayer, presumably on the basis of the facts.

May Lumber Co., 13 B.T.A. 62 (1928), involved a write-down of inventory for deterioration based upon years of actual experience. The Board allowed the write-down because it was based upon precise and accurate physical count and evaluation, not unexplained percentages used by petitioner herein.

Justus & Parker Co., 13 B.T.A. 127 (1928), is likewise inapplicable. That case involved a careful itemized valuation of each item of inventory by employees of the taxpayer, not broad applications of percentages as we have here.

The cases cited by petitioner and distinguished above fail to convince us that petitioner's method of valuing inventory clearly reflected income for tax purposes. Our holding herein does not disapprove of the use of percentages, per se; it disapproves those used by petitioner herein.

Because we hold that the adjustments of $926,952 to ending inventory on December 31, 1964, did not result in a clear reflection of taxable income for petitioner's taxable year 1964, it follows that the Commissioner did not abuse the discretion granted him by section 471 of the Code by reducing petitioner's cost of goods sold and restoring such amount to income. Alternative grounds relied upon by respondent will not be considered because we hold for him on the inventory issue for the reasons stated above.

Petitioner claimed a deduction of $136,150 as an addition to its reserve for bad debts for the taxable year 1965, which the Commissioner disallowed to the extent of $74,790.80. Petitioner's deduction was based upon analyses of its accounts receivable by its appropriate personnel. The reserve determined by the Commissioner was based upon an average of the taxable year 1965 and the preceding 5 years. The procedure adopted by the Commissioner is based upon *Black Motor Co.*, 14 B.T.A. 300 (1940), affd. on another issue 125 F.2d 977 (6th Cir. 1942).

An addition to a reserve for bad debts is permitted under the provisions of sections 166(c) of the Code.[9] The applicable regulations are contained in portions of section 1.166-4, Income Tax Regs.[10]

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9. SEC. 166. BAD DEBTS.

(c) RESERVE FOR BAD DEBTS.—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

10. Sec. 1.166-4 Reserve for bad debts.

(a) *Allowance of deduction.* A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of sec. 1.166-1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

(b) *Reasonableness of addition to reserve*—(1) *Relevant factors.* What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

(2) *Correction of errors in prior estimates.* In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

Section 166(c) gives the Commissioner the discretion to adjust the reserve for bad debts. To prevail, petitioner must show that the Commissioner abused such discretion. Petitioner contends that the abuse occurred because the Commissioner based his determination upon past history rather than current data on collectibility.

The burden on petitioner was to show that the Commissioner's determination was arbitrary, not that petitioner's method was better. *Massachusetts Business Development Corp.*, 52 T.C. 946 (1969). Petitioner did not show that conditions at the end of 1965 would cause collection of accounts receivable to be less likely than in prior years. We infer from the entire record that collectibility was probably more likely at the end of 1965 than it was in at least some of the years upon which the Commissioner based his average because new management had been infused into petitioner.

We hold, therefore, that the Commissioner did not abuse his discretion under section 166(c) of the Code in disallowing petitioner's deduction for addition to its reserve for bad debts in the amount of $74,790.80 for the taxable year 1965.

Decision will be entered under Rule 155.

OPINION BY JUDGE TONE

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

September 29, 1977.

Before

Hon. PHILIP W. TONE, *Circuit Judge*
Hon. HARLINGTON WOOD, JR., *Circuit Judge*
Hon. WILLIAM J. CAMPBELL, *Senior District Judge**

THOR POWER TOOL COMPANY, *Petitioner-Appellant*, No. 76-1476 *vs.* COMMISSIONER OF INTERNAL REVENUE, *Respondent-Appellee.*	Appeal from the Tax Court of the United States.

This cause came on to be heard on the transcript of the record from the United States Tax Court and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the United States Tax Court in this cause appealed from be, and the same is hereby, AFFIRMED, with costs, in accordance with the opinion of this court filed this date.

* The Honorable William J. Campbell, Senior District Judge of the United States District Court for the Northern District of Illinois, is sitting by designation.

In the United States Court of Appeals
For the Seventh Circuit

No. 76-1476

Thor Power Tool Company,
Petitioner-Appellant,

vs.

Commissioner of Internal Revenue,
Respondent-Appellee.

Appeal from the United States Tax Court.
William A. Goffe, *Judge.*

Argued December 7, 1976—Decided September 29, 1977

Before Tone and Wood, *Circuit Judges,* and Campbell, *Senior District Judge.**

Tone, *Circuit Judge.* Thor Power Tool Company appeals from a decision of the United States Tax Court, 64 T.C. 154 (1975), which upheld the Commissioner's disallowance of portions of Thor's write-down of its closing inventory for 1964 and its 1965 addition to a reserve for bad debts.[1] The issues

* The Honorable William J. Campbell, Senior District Judge of the United States District Court for the Northern District of Illinois, is sitting by designation.

1. Because the extensive write-downs taken for 1964, see text, *infra,* resulted in an operating loss for that year, part of which was carried back to 1963, the tax deficiency resulting from the Commissioner's disallowance was for 1963. The bad debt reserve issue relates to the taxes for 1965.

presented involve the income tax treatment of "excess" inventory and the method for calculating a reasonable addition to a bad debt reserve. We affirm.

I. *Inventory.*

A.

Thor manufactures tools and parts at three plants in its Tool Division and various rubber articles at a fourth plant in its Rubber Division. The corporation also maintains 24 sales and service branches in the United States and Canada. Inventories of parts, accessories, and completed tools are maintained at all branches and at the three Tool Division plants. Those three plants also maintain inventories of raw materials and work-in-process. The single Rubber Division plant keeps inventories of raw materials, work-in-process, and completed products.[2] Much of the inventory consists of replacement parts and accessories.

When Thor discontinued the manufacture of tools of a particular model, it nevertheless continued to stock replacement parts and accessories for tools of that model that were still in service. Thor began amortizing its cost of inventories of replacement parts and accessories for out-of-production tools in its 1960 tax return. This was accomplished by establishing an inventory contra account on the books of the company, and crediting that account with ten percent of the value of a part or accessory for each year since the termination of production of the tool of which the part or accessory was a component. The closing inventory was then written down to reflect this account, thereby increasing the cost of goods sold and reducing the reported net income. This practice was continued in the 1961, 1962, 1963 tax returns, without a challenge from the Commissioner. Further

2. The Tax Court observed that inventories of undetermined size were also maintained by Thor's distributors and several major customers. None of those inventories are involved in this case.

additions to the account were made for the first three quarters of 1964.[3]

In December of 1964 new management assumed the reins at Thor.[4] As part of its preparation of the 1964 financial statements, "a complete re-evaluation of the assets and liabilities of the company" was undertaken, including "a physical inventory . . . at all locations . . . ." The inventory was then "priced at 1964 inventory standards . . . ." [Tr. 90-91.] Once this was completed the management began to adjust the inventory valuation, in order to show the inventory at its "net realizable value," as required by the standards of the accounting profession, and to price the inventory at "the lower of cost or market," as had been Thor's practice for income tax purposes.

Write-downs totaling about $2,750,000 were made for obsolescence[5] and other reasons. These were not questioned by the Commissioner, because the items in question were scrapped soon after they were deleted from the 1964 closing inventory. A write-down of $245,000 was made for parts for three recent products that had not sold as well as expected. This too went unchallenged because the products were sold at lowered prices soon after the write-down.

The remaining inventory, consisting of some 44,000 items, was evaluated for the purpose of ascertaining the extent to which

3. A total of $152,117 was credited to the inventory contra account, and hence subtracted from net income, during 1960-63. Another $22,090 was credited to the account during the first three quarters of 1964, for subtraction at the close of that year.

4. A proposed merger of Thor into Stewart-Warner Corp. fell through in early December 1964, apparently because an investigation and audit convinced Stewart-Warner that Thor's assets were overstated. The purchase agreement between the two companies was rescinded by mutual agreement at that time, and Stewart-Warner agreed to provide management assistance to Thor. Accordingly, a Stewart-Warner employee assumed the presidency of Thor on December 14, 1964.

5. All parts of tools which had never been offered for sale and parts for which there had been no demand during 1964 were considered to be "obsolete."

it too was in excess of anticipated demand. Relying on its experience with manufacturing businesses, the new management estimated future demand for these items. At two of the Tool Division plants, estimates were based on 1964 sales figures, resulting in write-downs of $744,030.[6] Owing to the inadequacy of sales data for the other two plants, flat percentage adjustments were made to the valuations for parts, raw materials, work-in-process, and finished products in the physical inventory, resulting in write-downs of $160,832.[7] The $22,090 credit which the old management had entered in the inventory contra account for the first three quarters of 1964, see note 3, *supra*, was also subtracted from closing inventory.

These last three adjustments were disallowed by the Commissioner, as not "clearly reflecting the income" for 1964.[8] The

6. The gross usable inventory at these plants was reduced as follows:

(1) Items not in excess of 12 months' anticipated demand were not written down.

(2) Items in excess of 12 months' anticipated demand but not in excess of 18 months' anticipated demand were written down 50 percent.

(3) Items in excess of 18 months' anticipated demand but not in excess of 24 months' anticipated demand were written down 75 percent.

(4) Items in excess of 24 months' anticipated demand were written off completely.

7. Inventory was reduced by: (1) five percent for tool parts and motor parts at the third plant; (2) ten percent for raw materials, manuals and name plates, and work-in-process at this plant; (3) fifty percent for hardware at this plant; and (4) ten percent for raw materials, work-in-process, and finished goods at the fourth plant.

8. The statutory notice of deficiency received by Thor initially indicated a disallowance of $1,079,069, which was the total credit balance in Thor's inventory contra account at the close of 1964. This figure was derived by adding the above described credits to the account taken during 1964, which totaled $926,952, to the year-end 1973 account credit balance of $152,117.

The credit balance in the inventory contra account at the end of each year was reflected on Thor's income tax return for that year as a reduction of closing inventory. Thus, only the net addition to the

(Footnote continued on next page.)

Tax Court upheld the Commissioner, on the ground that Thor's write-down of excess inventory was not permitted by the Treasury Regulations.

B.

Section 446 of the Internal Revenue Code, 26 U.S.C. § 446, provides that taxes shall be computed in accordance with the taxpayer's usual method of accounting, unless that method does not clearly reflect income.[9] The taxpayer's method of accounting is thus given preference. *Lincoln Electric Co.* v. *Commissioner*, 444 F.2d 491, 494 (6th Cir. 1971); *Photo-Sonics, Inc.* v. *Commissioner*, 357 F.2d 656, 658 n.1 (9th Cir. 1966). If, however, in the opinion of the Commissioner, that method does not clearly reflect income, the Commissioner may require that another method be used. *Brown* v. *Helvering*, 291 U.S. 193, 203 (1934); *Bangor Punta Operations, Inc.* v. *United States*, 466 F.2d 930, 935 (7th Cir. 1972).[10] The Commissioner possesses "broad powers in determining whether accounting methods used by a taxpayer clearly reflect income." *Commissioner* v. *Hansen*, 360 U.S. 446, 467 (1959).

(Footnote continued from preceding page.)
account during any particular taxable year increased Thor's cost of goods sold and reduced its taxable income for that year. Inasmuch as the Commissioner was only challenging Thor's 1964 return, yet the deficiency notice also included the 1964 opening balance, the Commissioner conceded before the Tax Court that only the credits totaling $926,952 were at issue. The Commissioner did not, however, concede the propriety of the methods by which the 1964 opening account credit balance was obtained. We express no views on this.

9. 26 U.S.C. § 446:

> ". . . Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books . . . [unless] the method used does not clearly reflect income, [in which case] the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."

10. Treas. Reg. § 1.446-1(a)(2) provides, *inter alia*, that "no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income."

The Commissioner's discretion is, if anything, greater with respect to inventory accounting. *Waukesha Motor Co.* v. *United States*, 322 F.Supp. 752, 768 (E.D. Wis. 1971). Section 471, 26 U.S.C. § 471, provides:

> "Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The statute thus sets up a two-part standard on which the Secretary or his delegate, the Commissioner, is to act: the taxpayer's inventory method must both conform closely to the relevant "best accounting practices" and clearly reflect income. These two are usually linked, however, because an accounting method which "reflects the consistent application of generally accepted accounting principles in a particular trade or business . . . will ordinarily be regarded as clearly reflecting income . . . ." Treas. Reg. § 1.446-1(a)(2). The same principle was applied to inventory accounting in a sentence which appeared in the regulations until 1973:

> "An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of a taxpayer can, as a general rule, be regarded as clearly reflecting his income."

Treas. Reg. § 1.471-2(b).[11] See also *Commissioner* v. *Joseph E. Seagram & Sons, Inc.*, 394 F.2d 738, 742-743 (2d Cir. 1968).

As the words "ordinarily" and "as a general rule," and the two-part standard itself, suggest, however, there can be circum-

11. In 1973 this sentence was deleted by an amendment which the Tax Court properly held inapplicable to the case at bar. That amendment also added the requirement that accounting methods be "consistent with" the regulations to Treas. Reg. § 1.446-1(c)(1)(ii). See T.D. 7285 (approved Sept. 13, 1973), 1973-2 Cum. Bull. 163.

stances in which the best accounting practice does not clearly reflect income. Thus the accounting profession's indorsement of a practice as "the best accounting practice," even if accepted by the Commissioner, does not require him to determine that the practice clearly reflects taxable income. *Schlude* v. *Commissioner*, 372 U.S. 128 (1963); *American Automobile Association* v. *United States*, 367 U.S. 687, 693 (1961). This is because the goals of balance-sheet and income-tax accounting are not identical. Mr. Justice Clark, in *American Automobile Association* v. *United States, supra*, speaking of the accounting system before the Court, said that it "presents a rather accurate image of the total financial structure, but fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner." 367 U.S. at 692. The criteria referred to were stated by Justice Brandeis in *Lucas* v. *Kansas City Structural Steel Co.*, 281 U.S. 264, 268 (1930):

> "The Federal income tax system is based upon an annual accounting period. This requires that gains or losses be accounted for in the year in which they are realized. The purpose of the inventories is to assign to each period its profits and losses."

Whether a given method of accounting clearly reflects income is a question of fact. *Artnell Co.* v. *Commissioner*, 400 F.2d 981, 983-985 (7th Cir. 1968). As the Supreme Court has stated, it is not our role, in reviewing the Commissioner's exercise of his discretion, "to weigh and determine the relative merits of systems of accounting." *Brown* v. *Helvering, supra*, 291 U.S. at 204-205. Thus, in order to overturn the Commissioner's disallowance, the taxpayer must show that the Commissioner's act was "plainly arbitrary." *Lucas* v. *Kansas City Structural Steel Co., supra*, 281 U.S. at 271; *Bangor Punta Operations, Inc.* v. *United States, supra*, 466 F.2d at 935.

C.

The Tax Court held in this case that under § 471 of the Internal Revenue Code of 1954 the Secretary is to prescribe the

methods by which inventories are to be taken, and that the Treasury Regulations set forth those methods. While the court found that Thor's write-downs of excess inventory constituted a "best accounting practice" within the terms of the statute, it also held, without elaboration, that Thor had failed to establish that its inventory accounting clearly reflected its 1964 income, thus falling outside the general language of the regulations. The Tax Court therefore required Thor to demonstrate that its method satisfied one of the specific regulations. Because the regulations did not authorize Thor's treatment of its "excess inventory," the court upheld the Commissioner.[12] Thor argues that the Tax Court erred in not allowing it to take advantage of a "presumption" that best accounting practice will clearly reflect income. Thor contends this was created by the sentence formerly included in Treas. Reg. § 1.471-2(b). See text at note 11, *supra*. Thor also argues that the court erred in requiring it to demonstrate that its inventory accounting was explicitly authorized by the regulations, and in holding that the regulations did not authorize the method used.

The Tax Court's finding that Thor's treatment of inventory for 1964 conformed to best accounting practice is not clearly erroneous and is not seriously challenged by the Commissioner. The remaining issues relate to whether that treatment most clearly reflected income and can best be discussed in the following sequence: (1) Was Thor's treatment authorized by specific regulations? (2) Was it authorized by general regulations? (3) If it was neither authorized nor forbidden by any regulations, and the Commissioner nevertheless was required to determine

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12. The Tax Court therefore did not reach the Commissioner's alternative arguments, *viz.*, that Thor's new inventory valuation procedures constituted a change in its method of accounting, without the Commissioner's permission, and was therefore impermissible, or that Thor's 1963 income was not clearly reflected because it failed to revalue its 1964 opening inventory in accordance with the methods used to value its closing inventory.

whether it clearly reflected income,[13] did he abuse his discretion in determining that it did not? We answer these questions in the negative and then go on to hold, see (4), *infra*, that the Commissioner did not abuse his discretion in determining that inventory which was not yet scrapped could not be written off for tax purposes.

(1)

We uphold the Tax Court's determination that Thor's write-downs of excess inventory did not fall within the specific regulations. Treasury Regulation § 1.471-2(c) permits the taxpayer to use special valuation procedures for inventory goods which the taxpayer proves are "unsalable at normal prices . . . because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes . . . ." Thor failed to carry its burden of proving that its excess parts and accessories were within the descriptive phrase. *E. W. Bliss Co.* v. *United States*, 224 F.Supp. 374, 378 n.1 (N.D. Ohio 1963), *aff'd on the opinion below*, 351 F.2d 449 (6th Cir. 1965). We accept the view of the Commissioner and the Tax Court that the words "other similar causes" do not extend the coverage of the regulation to units which, in management's opinion, are "excess." As the Tax Court observed, excess inventory is not distinguishable from other units of inventory. All the tool parts and accessories were in essentially the same condition—they were commingled and interchangeable. See *Lucas* v. *Kansas City Structural Steel Co., supra*, 281 U.S. at 270-271. See also *Cleveland Automobile Co.* v. *United States*, 70 F.2d 365, 368-369 (6th Cir.), *cert. denied*, 293 U.S. 563 (1934). Moreover, at least with respect to the finished products, Thor did not meet the valuation requirements of this regulation. No "actual offering" at below "normal prices" was made within 30 days of the inventory, and therefore no bona fide selling price could be calculated.[14] Thor cannot be permitted to do what the Sixth Circuit forbade in *Cleveland Automobile Co.* v. *United States, supra, viz.*,

> "by a consideration of all factors then known and those later discovered . . . thus substitute for the actual selling price required by the regulation a suppositious selling price which the Commissioner and the court must accept because it conforms to good accounting practice."

70 F.2d at 369. See also *John L. Ashe, Inc.* v. *Commissioner*, 214 F.2d 13, 15 (5th Cir. 1954).

Nor does the excess inventory come within Treas. Reg. § 1.471-4.[15] As noted above, the units of excess inventory are "normal" goods, unlike the custom-built presses involved in the *Bliss* case, on which Thor chiefly relies. The fact that they may be in excess of Thor's future needs is not an exceptional circumstance permitting their market valuation to be set at other than their replacement cost. *Knapp King-Size Corp.* v. *United States*, 527 F.2d 1392, 1399-1400 (Ct. Cl. 1975); *D. Loveman & Son Export Corp.* v. *Commissioner*, 34 T.C. 776 (1960), *aff'd on opinion below*, 296 F.2d 732 (6th Cir. 1961), *cert. denied*, 369 U.S. 860 (1962). Thor's own chief executive officer stated that "any business which is involved in the manufacture and sale of products inevitably must have excess inventory," that this was particularly true in "the kind of business that

13. We assume that if a particular situation is not covered by a general or specific regulation, the Commissioner would nevertheless be obligated to apply the two-part standard to the facts of that case. Section 471, in speaking of the individual taxpayer, suggests as much.

14. Treasury Regulation § 1.471-2(c) provides that unsalable goods "should be valued at bona fide selling prices less direct cost of disposition . . . . Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date."

15. This regulation governs inventories valued at the lower of cost or market, as was Thor's. Subsection (a) provides the general definition of "market," which applies "[u]nder ordinary circumstances and for normal goods in an inventory . . . ." Subsection (b) establishes procedures for inventory valuation "[w]here no open market exists or where quotations are nominal, due to inactive market conditions . . . ." In such circumstances "the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales . . . or compensation paid for cancellation of contracts . . . ."

Thor was in . . . which involves a very high percentage of service parts and accessories," and that many manufacturing costs are "independent of quantity." [Tr. 95-97.] Furthermore, a senior member of a leading accounting firm who was called as an expert by Thor testified that "most corporations in that type of business do carry a fairly good inventory in terms of quantities and diversified parts for most of their models . . . ." [Tr. 349.] Thus, in Thor's business it was considered wise to produce in advance all the parts that were expected to be sold over several succeeding years.[16] Of necessity, these parts were then carried in inventory. Therefore, we cannot say that the Tax Court erred in holding that the accumulation of excess inventory is not an extraordinary circumstance justifying valuation of inventory under Treas. Reg. § 1.471-4(b) in a manufacturing business such as Thor's, with its extensive inventory accumulated for service and repair purposes.[17]

(2)

As we have noted, the regulation dealing with accounting practices generally, Treas. Reg. § 1.446-1(a)(2), and the former provision in the regulation dealing with inventory, Treas. Reg. § 1.471-2(b), simply provide that the best accounting practice will ordinarily produce a result that most clearly reflects income. Thor contends that these provisions established a presumption in its favor. The weakness in this argument is exposed, however, by the sentence in the latter regulation which immediately precedes the sentence on which Thor relies. That preceding sentence is as follows:

16. As the American Institute of Certified Public Accountants observed in a comment it prepared on proposed amendments to the inventory regulations under § 471, "the cost of producing additional parts, in the event that actual future need is greater than presently estimated, would be prohibitive." [Ex. 29, pp. 4-5.]

17. Our conclusion is consistent with the AICPA's acknowledgment in its statement on proposed inventory regulations, see note 16, *supra*, that "the problem of determining appropriate cost for inventory quantities in excess of prospective demand" is "[a]n important valuation matter not covered" by the present regulations.

> "In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is in accord with sections 1.471-1 through 1.471-11."

The Tax Court, although it did not reach the related issue of internal inconsistency during 1964, see note 12, *supra*, did infer that the excess inventory Thor attempted to write off in 1964 had been accumulated "over a period of several years." This inference was appropriate, in view of the fact that the merger with Stewart-Warner was called off in part because Thor's inventory valuation was excessive, see note 4, *supra*, and the fact that the new management adopted a valuation method which resulted in overall write-downs of nearly $4 million in 1964, as compared with a small fraction of that amount in the preceding years. As the Tax Court implied in questioning an expert witness called by Thor, this large discrepancy was enough to indicate that consistency was lacking. [Tr. 371-375.] Hence if any "presumption" was created by the regulations, it was dissipated by this lack of consistency. Inventory accounting for income tax purposes must serve the ultimate goal of matching costs and revenues so the profit or loss of a particular year is accurately reflected. *United States Cartridge Co.* v. *United States*, 284 U.S. 511, 520 (1932); *Photo-Sonics, Inc.* v. *Commissioner, supra*, 357 F.2d at 657. Thus Thor had the burden of proving before the Tax Court that its treatment of inventory more clearly reflected income than did the Commissioner's. *Peterson Produce Co.* v. *United States*, 205 F.Supp. 229, 241 (W. D. Ark. 1962), *aff'd*, 313 F.2d 609 (8th Cir. 1963).

(3)

The Tax Court's finding that Thor did not prove its 1964 income to have been clearly reflected was not clearly erroneous. *Cf. Resnik* v. *Commissioner*, 555 F.2d 634, 636 (7th Cir. 1977). Thor's argument to the contrary is not supported by the

expert testimony it adduced. The highly qualified members of the accounting profession Thor called as experts did not testify that its 1964 income had been clearly reflected in its tax return, or that the accounting method used was necessary in order to state the 1964 income. Thor's independent auditor (who did not become such until 1970) testified merely that his analysis of Thor's 1964-1971 inventory reserves and results of operations demonstrated that Thor's write-offs of "excess inventory" were not excessive. [Tr. 162-167.] Neither his testimony nor that of the other experts compelled a finding that the Commissioner had abused his wide discretion.

(4)

Inventory valuation under the lower-of-cost-or-market method adopted by Thor is "a limited exception to the principle of annual accounting." *Space Controls, Inc.* v. *Commissioner,* 322 F.2d 144, 148 (5th Cir. 1963). In conceding that exception, however, the Commissioner has not abandoned completely the rules that require realization. Thus, the Commissioner requires taxpayers to prove "closed transactions or identifiable events" as a basis for inventory valuations, in order to reduce their opportunities to determine unilaterally how much profit or loss to report in any given year. This is the purpose of Treas. Regs. §§ 1.471-2(c) and 1.471-4(b), which require the taxpayer to offer evidence of valuation, such as discount sales or contract cancellations. Accounting principles may well require that reserves be maintained to reflect declines in value of goods held in inventory, despite the absence of such "identifiable events." But, as Mr. Justice Brandeis observed in *Brown* v. *Helvering, supra,* 291 U.S. at 201-202:

> "Only a few reserves voluntarily established as a matter of conservative accounting are authorized by the Revenue Acts. . . . Many reserves set up by prudent business men are not allowable as deductions."

See also *American Can Co.* v. *Bowers,* 35 F.2d 832, 835 (2d Cir. 1929), *cert. denied,* 281 U.S. 736 (1930). See generally *United States* v. *American Can Co.,* 280 U.S. 412, 419 (1930);

Lucas v. *American Code Co.,* 280 U.S. 445, 452 (1930). In exercising his broad discretion under § 471, the Commissioner may require that the losses on excess inventory actually be realized, *e.g.,* through scrapping, before they may be subtracted from sales.[18] That is apparently what he required in this case, as is demonstrated by his allowance of the $245,000 write-down for excess inventories of three products that Thor actually sold off at lower prices. [Tr. 70, 99, 109.] Accordingly, we affirm the judgment of the Tax Court with respect to the inventory valuation issue.

II. *Bad Debt Reserve*

The second issue before us involves Thor's 1965 addition to its reserve for bad debts. At the close of 1965 the collectibility of all accounts receivable was estimated by the Thor personnel most familiar with each account and their estimates were reviewed by three levels of management. All inter-company accounts were treated as fully collectible. A 100 percent reserve was established for the two Rubber Division accounts determined to be wholly uncollectible, and a one percent reserve was established for the remaining receivables in that division. The credit clerks in the Tool Division evaluated each 90-day-old account of over $100, and made an individual determination as to its collectibility. Again a 100 percent reserve was set aside for those accounts which were considered wholly uncollectible. The dollar ratio of uncollectible accounts to total over-$100 accounts was then applied to the 90-day-old accounts with a balance of under $100, to determine the dollar reserve to be set aside on these smaller accounts. Flat two percent reserves were set aside for all other 90-day-old accounts and all accounts between 30 and 90 days past due. A one percent reserve was established for all accounts less than 30 days old.

18. Compare, as to obsolete goods, *C-O-Two Fire Equipment Co.* v. *Commissioner,* 219 F.2d 57 (3d Cir. 1955). The distinction is understandable in light of the fact that the regulations specifically allow deductions for obsolete property. See *United States Cartridge Co.* v. *United States,* 284 U.S. 511, 516-520 (1932).

These computations resulted in a total addition to the bad debt reserve, *i.e.*, a total deduction from income, of $135,150. The Commissioner, however, recomputed what he considered to be "a reasonable addition" to the reserve, by applying the six-year moving average, or *Black Motor* formula to the 1965 accounts receivable.[19] He divided the total of accounts written off by Thor during the tax year in question and the five preceding years by the total of year-end receivables for all six years. The resulting percentage was then applied to the 1965 year-end receivables, and the $74,790.80 by which Thor's claimed deduction exceeded the product of this calculation was disallowed.

Reasonable additions to a reserve for bad debts may be deducted pursuant to § 166(c) of the Internal Revenue Code of 1954.[20] As the Code makes clear, the Commissioner is to exercise his discretion regarding the reasonableness of any particular addition. In order to overturn the Commissioner's disallowance, therefore, the taxpayer must show that the Commissioner has abused his discretion. *Calavo, Inc.* v. *Commissioner,* 304 F.2d 650, 653-654 (9th Cir. 1962). This is a "heavy burden." *Consolidated-Hammer Dry Plate & Film Co.* v. *Commissioner,* 317 F.2d 829, 834 (7th Cir. 1963). As we have stated before, the issue thus presented "is whether the Commissioner's view is reasonable." *The First National Bank of Chicago* v. *Commissioner,* 546 F.2d 759, 761 (7th Cir. 1976), *cert. denied,* 97 S.Ct. 2176 (1977); *S. W. Coe & Co.* v. *Dallman,* 216 F.2d 566, 569 (7th Cir. 1954). If it is, the inquiry is ended. We agree with the Tax Court that the Commissioner's method of determining the reserve for bad debts, which gave preference to experience over estimates, was reasonable.

AFFIRMED.

19. The procedure is described in *Black Motor Co.,* 14 B.T.A. 300 (1940), *aff'd on other grounds,* 125 F.2d 977 (6th Cir. 1942).

20. 26 U.S.C. § 166(c) provides:

"*Reserve for Bad Debts.*—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts."